

Franchise Development – Doing It Right

By: Michael H. Seid, founder and managing director, Michael H. Seid & Associates - MSA

For those of us experienced in franchising, we are often amazed when companies considering the establishment of a new franchise system, even large, well established, international companies, begin the process at the end - the development of the legal agreements. Presented with a lengthy questionnaire by their legal counsel, they are asked to provide information necessary to prepare franchise agreements and disclosure documents. The problem though is that the questions are often their main guide to how their franchise system should be structured.

As a potential franchisor you may not fully understand all of the questions or have an independent frame of reference to know what all your available options truly are. The attorneys, knowledgeable in the law and prior agreements often will provide you with advice and direction. However, without the benefit of being able to evaluate business alternatives, conduct research and fully explore the strategic considerations that most of these decisions require, the franchise system will often end up operating as a legal vehicle for expansion rather than what it truly should be, a business structure for expansion.

Since the franchising process began with the development of legal documents, new franchisors may view their franchise system as a legal device governed primarily by the rule of law. Experienced franchisors understand that while the law is an element of franchising, it truly is a minor portion of the way franchisors manage their business, make decisions on its direction or how they interact with their franchisees.

If you think about legal agreements taking the lead in the franchise development process, it would be similar to an attorney asking you questions necessary to draft leases on a residential building before the market studies are conducted, the location is selected, the engineers have completed their site review, the building is designed, the financing is in place, the permits are obtained, the builder has been selected or even the costs for construction and management are known. Only in franchising, especially if it is your first time developing a system, the issues are more complex and the risks extend not only to your company and its stakeholders, but your future franchisees

Keep in mind; while you may have an operating business with a long history and experienced management, you are developing a new business - a franchise system. It should be the structure of that business that you focus on first, not the structure of the legal agreements. Therefore, before you begin to develop your legal agreements, before you invest in the creation of a franchise system, before you print brochures, hire your franchise staff and start selecting franchisees, the first thing you need to do is understand that franchising is a business. All the legal documents should do is describe the business and the terms you are offering to your franchisees.

The process of basing your business strategy on legal questionnaires is simply insufficient for the design, development, long-term growth, management and financial well being of your franchise system.

In the beginning ...

So, where should you begin?

The first issue is to determine if your business is ready to expand and whether franchising is an appropriate strategy for your company. Before a single franchisee exists, there has to be a franchisor. And before a company begins what can be a costly process of developing a franchise program, it's prudent to have a franchise feasibility conducted.

Only after the feasibility examination is conducted should you begin the work on developing the franchising strategy. The development of the legal agreements is one of the last elements of that process.

A franchise feasibility examination measures a company against recognized benchmarks typically used in franchising. It is designed to assist a company's management in making a determination whether they are ready to expand and whether franchising is the correct growth strategy. It also explores other methods of expansion that may be available and better suited for the company.

But, even before conducting a feasibility examination there is a simple test used to determine if a business is not franchisable or ready for expansion. If the existing business:

- Is only a concept and has not commenced operations;
- Has only a limited operating history;
- Is not profitable at the unit level; and,
- Does not currently achieve a reasonable return on investment, at the unit level

It's not franchisable – at least not yet.

To be franchisable, the business has to be a business and that business must at least be profitable and achieving a reasonable return on investment.

Think of the elements in a franchise system that you should be offering to future franchisees. One of the principal elements is your experience in operating the business to be franchised. If that experience doesn't exist, or is so minimal as to be negligible, all that you are really offering potential franchisees is the opportunity of being a guinea pig. While legal counsel could develop franchise documents sufficient to offer franchises for a business that never existed, and, you might even find individuals willing to buy your franchise, the risk of failure for both the franchisor and franchisee will be high. Unfortunately, with the abundance of franchise packaging firms (both consultants and attorneys) existing in franchising today, those "opportunities" exist.

When conducting a feasibility examination we review business and financial benchmarks. The benchmarks used depend on the industry segment, the company and other determinants but broadly fall into a few interrelated and interdependent buckets including: the underlying business; its products and services; how well the business can be systematized for new and existing franchisees; the skills required by franchisees to operate the business; the organization and support required to manage and grow the system; the potential for expansion; and, the underlying business economics.

It's not possible to discuss in depth here all of the elements that require review in a feasibility examination. Even in *Franchising for Dummies*, we touched on the issues of feasibility only in one chapter. But, let's examine some of the highlights.

The underlying business

As we said before, you need an operating business before you begin to franchise. But, is it really enough to have only one location before you begin to expand? In a practical sense, two would be better but probably more are required.

Several locations in different neighborhoods or areas will give you an indication of whether your business is a single unit local market phenomenon or something that has wider consumer appeal. Possibly more important though is how long you have operated the business. Understanding how it operates in different seasons, whether it can be successful against the competition, who its customers are and what they really think of the concept may be more important than the number of locations you presently operate. Keep in mind that others are going to have to follow in your footsteps - will they be able to based upon your experience and knowledge of your industry?

What you are trying to develop is a chain of businesses using the same name, usually the same look and almost certainly the same methods of operation. To secure and maintain a “brand personality” that consumers recognize and can rely upon every time they hear your brand mentioned requires consistency. Having a business that you can model for successful duplication is essential in determining franchisability.

Let’s not forget about the product or services your franchisees will be offering to the public. Are they any good? Are sales based upon a well-established consumer demand or only a passing fad? How are your products and services different – and hopefully better – than those offered by the competition?

Understanding who your competition is, and what actions they are likely to take in the marketplace not only allows you to make a determination of whether your offering is sufficiently competitive, it enables you to begin to be proactive in responding to the expected market changes. You will also need, in examining your options for expansion, to determine whether consumers will want or need your product or services tomorrow. Understanding their buying patterns and changes in the marketplace is essential in understanding the long-term popularity of your product or services.

Do you understand the competitive landscape? Is it likely that other companies will be able to absorb your product and services into their consumer offering? If you don't think it is possible, look what happened to the frozen yogurt market when every ice cream stand and green grocer added frozen yogurt machines. Notice the impact on the bagel franchises when Dunkin Donuts added bagels? Do you wonder about the future strength of the smoothie market as other chains add it to their menus? They will likely have to change from a single product offering simply to survive, but will that cause them to lose their competitive distinction.

What will changes and improvements in technology do to your consumer offering? Will it make your product or service unnecessary or necessary less often? Remember when cars needed a tune up every 15,000 miles? Well today, it's closer to 100,000 miles and requires equipment and expertise not thought of 15 years ago. Notice the reduction of specialized tune up shops. Remember when the automotive dealers did a poor job, had miserable service and charged more for an oil change than you paid for the car? More customers today are going back to their dealer for routine maintenance. Improved technology and changes in customer service certainly had an impact on the franchised

automotive aftermarket and many franchise systems had to evolve from their original concepts.

Understanding your true competitive position, not only against other franchise systems but also against everyone who offers your product or service is critical. Understanding how market conditions will affect your offering is essential in looking at the feasibility of expansion and franchising.

The systematization of the business

When consumers walk into any branded location, they have expectations of what their experience will be like. Interesting thing about branded locations. Before consumers ever walk through the door, based upon their experience at other locations or based upon recommendations of others who have shopped at other locations, they have expectations about how you operate. Making their expectations into a shopping reality requires that the business operate consistently from location to location.

During the feasibility examination, ensuring that consistency is possible requires a few assessments to be made including:

- Whether the business, at the unit level, can be defined and broken down into clearly defined steps that can be included in operating procedures and manuals; and,
- Whether franchisees and their staff can be taught within a reasonable period of time, and at a reasonable cost to execute those steps.

These determinations also necessitate an analysis of whether the prospective franchisee or their future staff requires any specialized skills or licenses before they become franchisees.

Available franchisees

Depending on the skills or licenses your franchisees or staff requires may reduce the pool of available candidates and have an impact on the ability of the franchisor to find people able to meet their expansion goals.

Just as when we said earlier, “ Before there is a single franchisee there has to be a franchisor”. Well before there is a franchise system there has to be someone willing and able to become a franchisee. Are they out there?

It's not sufficient to guess whether a pool of potential franchisees exists. Simply knowing whom your potential franchisee might be is not enough. You also need to know whether the pool of candidates available to purchase your franchise will be sufficient to meet your expansion goals. Even if you determine that the pool of potential franchisees is adequate, are you certain that they would be interested in your franchise. If they are, will they be able and willing to make the required investment? Answering questions about the marketability of your franchise offering and the extent that it can be marketed is essential in determining whether your business is franchisable.

In determining whether there is likely to be a sufficient pool of franchisees to meet your expansion requirements, at a very basic level, requires you to determine

- What basic skills will your franchisees will need?

- Will they be able to hire employees with the needed skills if they may not have them?
- If they can't hire skilled staff, will your training program give their staff the necessary skills?

You can't wait until you begin to offer franchises to have answers to questions about your system's marketability. You may find out that you have all of the documents required to invite people to come to your party but nobody shows up to help you blow out the candles. One of the reasons so many new franchisors experience little if any growth in their systems is that the pool of candidates was never adequate for their purpose, and a feasibility examination might have determined that before they began the development of the system.

The support system and fees

It's simply not enough for you to simply sell franchises to call yourself a franchisor. Expansion of the system is only one goal. The management of a growing and profitable system is your long-term objective.

Good franchisors today provide support and other services to their franchisees sufficient to give them a sustainable competitive advantage over the competition. Will you be able to provide the necessary support? During the feasibility examination you will need to determine:

- The types of headquarters and field support services that will be required and how and when you will provide those services, and
- The cost of developing and providing those services

Establishing fees and other sources of revenue will be a significant focus when you begin to design and develop your franchise system. But, during the feasibility examination, making certain that sufficient income will be available is essential in determining whether your business can expand through franchising.

It is important to remember that ultimately the fees and other sources of revenue will need to meet two tests:

First, they will need to provide the franchisor with sufficient income to provide the services required while providing for a reasonable return on their investment for developing and operating the franchise system.

Second, when paid or incurred by the franchisee, the franchisee will have sufficient revenue to be profitable and there will be sufficient residual income to ensure a reasonable return on their investment.

Setting appropriate fees is one of the most difficult decisions a franchisor will have to make. If you set your fees too high, your franchise may not be marketable against the competition and your franchisees may not be profitable. If you set them too low, your franchise may be marketable but you may not have enough revenue to provide the services needed to your franchisees. Neither alternative is satisfactory.

However, we often find in discussions with clients who are already operating a franchise system that their franchise fees were set primarily by profiling those of their direct franchise competitors. When you think about it, even if franchisees offer the identical product or services as their competitors, their investment, sales or cost of operation will not be identical to those of their direct competitors. Even if the franchise system looks the same as others, the same cost structure, growth

strategy, exit strategy and a host of other variables will not be the same. Establishing fees based primarily on those of the competition is not only foolish, it's potentially dangerous since the fees need to be based upon the reality of the business being franchised.

Unfortunately, many new franchisors who do not strategically develop their franchise system and who do not sufficiently understand the system's economic realities simply review the listings contained in publications like the Entrepreneur 500, determine what the competition is charging their franchisees and set their fees lower. If all you have to offer a franchisee is lower fees, do you really have anything worthwhile to offer? If the fees you select are too low or too high, the impact on the future franchise system can be dramatic.

As an inelastic method of distribution, that is one that is governed by long-term contracts where changes in the fee structure during the term will be difficult if not impossible, franchisors will have to live with the fees they set initially, at least for those franchisees that enter under that contract. In addition, setting ongoing fees simply as a percentage of gross sales may be routine for most franchisors, but it may be the wrong structure for your system. Changing how you charge royalty fees will be equally disruptive.

The feasibility examination should provide some assurances that once developed, the franchise system will be able to meet the financial expectations of the franchisor and future franchisees. During the strategic process, when all of the variables are examined in detail and the costs are better known, the final rate and structure of the fees can then be determined.

Your ability to expand

By definition, the reason companies enter into a franchised method of distribution is to expand. What are your goals for expansion? Are they realistic and achievable?

Few franchisors come out of the box and successfully develop into a national chain overnight. Many, because they do not have a market development strategy, allow the phone calls to determine their expansion strategy and find themselves with one location here and the next one a thousand miles away. Spending all of your royalty in travel to a distant franchisee or worse, not visiting that franchisee because you can't afford to is a reality for some new franchisors.

Making certain that you have available markets where you can economically support growth and achieve the required critical mass to sustain franchisee profitability is extremely important for new franchisors. At a bear minimum, market studies to determine that you have available expansion options and where and when you should expand will be required. You will also need to decide how you will expand into the markets. Entering core markets and tertiary markets will likely require different strategies. Will franchisees that meet the requirements of each type of market be available?

None of the elements of a franchise system really stands on its own. Each element rests, to some degree on your ability, to achieve the others. However, realistically assessing your potential through a feasibility examination will enable you to determine not only whether you should expand but will also assist you in determining what may still need to be accomplished before you are ready.

But, conducting a feasibility examination is only your first step in franchise development. Developing legal agreements is still far down the path.

Designing the franchise system

You should view the feasibility examination as a 30,000-foot high look at your future franchise system. The process of designing and developing a franchise program will bring you down to ground zero.

The design and development of a franchise system will require that you evaluate each element of the future franchise system, determine how it integrates with other elements, make changes based upon the information collected and begin the development of the tactical elements you will require.

The process will differ for each company and each industry but the elements will contain similarities. If the feasibility examination was conducted properly, you will be able to build and expand on the elements you reviewed during the feasibility process.

Some of the broad strategic and tactical elements will include:

- Existing management's capabilities and other staff that you will require in managing and growing the franchise system.
- Competition both at the franchise and consumer level
- Potential conflicts between the franchisor and franchisee and methods to reduce or eliminate these problem areas
- Economic impact of franchising on the franchisor and franchisees including investment, cash flows and return on investment
- Financing requirements and exit strategies for the franchisor and franchisees

- Market strategy including market approach, targeted markets, critical mass requirements, franchisee profile, structure of the franchise relationships used, selection criteria as well as marketing, closure and sales compliance strategies.
- System information and management including accounting, IT and point of sale systems, among others and the use the system makes of the information available.
- Policy formation including, real estate, advertising, territorial rights, supply chain management, terms of the franchise offering, equipment, signage, etc.
- Training programs and manuals including what is included in the training programs and manuals, participants who will attend training, other training required or offered, costs for training, locations, procedures, training staff, etc.
- Monitoring mechanisms including site selection and development, operating standards, financial management, sales and marketing, trademark usage, in-system operating and qualitative evaluation, competitive analysis, etc.
- Support programs including headquarters support, field support, ongoing visits, contact reports, research and development, motivation programs, franchise relations programs, system communication, etc.
- Ongoing services and programs including cooperatives, advisory counsels, etc.

This is only a preliminary list but only after these and a host of other elements are evaluated for inclusion into the system, their cost for development and implementation is determined and their impact on the revenue and expenses for the system, at all levels, are determined, can you properly determine the fee and other structural elements of the franchise system. Only then can you truly

provide proper information to your legal counsel for the development of the required franchise legal documents.

The reason usually given for why franchisees are better prepared to operate their new businesses than independent business owners is that the franchisor is prepared to provide them with the necessary tools and structure. Where new franchisors shortcut the process, skip the necessary evaluations and the development of the underlying components and move directly into the development of legal documents, it is unlikely that the benefits of franchising can truly be realized for either them or the franchisees. Planning and evaluating the underlying system is the first step in providing franchisees with the tools they require to succeed.