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FRANCHANSING AS A MODERN CONCEPT OF BUSINESS DEVELOPMENT

Most franchise networks do not begin with firm plans or any thought at all, relating to franchising. Without regard to whether the business operates from a single location or several outlets, whether to expand, and if so, the method to use, frequently is a question generated by the success of the business after several years of operation. Whether to expand at all should, of course, precede consideration of method. Many businesses are not easily expanded into a network of outlets. Many entrepreneurs are not temperamentally suited to manage expansion and will be happier, and probably more successful, operating their original businesses or growing only to a second or third outlet in the same city. The determination of whether or not to expand can be considered the first step.

Once the decision to expand is made, the different methods by which expansion can be accomplished will naturally be considered. One obvious method is the establishment of additional outlets patterned on the original business and financed with its net cash flow, debt, equity from friends and relatives or a combination of one or more of these sources. Expansion by this method is slow and may strain the management (see the Introduction to this book for a discussion of this method of expansion). A variation on this method would be the establishment of first ventures, either with passive investors (a financing device) or active operators to insure that owner-operators will be responsible for the management of each outlet). Finally, the business owner will likely consider franchising.

The method chosen is likely to be influenced in part by the goals of the business owner.

If the goal is a relatively small, local chain of outlets, expanding with company owned outlets, or possibly joint ventures with passive investors, probably is the most sensible method. If the goal is to build a regional or national, network of outlets, franchising is the logical choice. In many instances a decision is made to expand with both company owned outlets and franchisees, perhaps by establishing the original market as a company store territory with franchising reserved for other metropolitan areas. In order to develop in new markets, a few franchise networks have established company outlets in such markets and ultimately sold them to franchisees. In many larger franchise networks the ratio of company and franchisee operated outlets has fluctuated greatly during the past two decades, most recently tending toward a greater percentage of franchisee ownership. The selection of the method(s) of expansion can be considered step two.

The selection of franchising as an expansion method should be made subject to meeting the criteria, and the willingness of the owner to follow the guidelines, discussed in this chapter.

The success of the company's brand will be determinative of the success of its expansion by franchising and developing and enhancing a successful brand in a franchise network is a complex and demanding endeavor. As will be discussed at length below, franchising is much more than selling franchises and opening outlets.

Franchising has been used extensively as a method of expanding businesses in 75 or more business classifications, and has therefore been an effective business relationship for a wide variety of businesses. This rapid growth of franchising in a wide, and ever increasing, variety of service and product businesses has influenced many would be franchisors to believe that franchising is a relatively simple business technique, readily applied to almost any business. As noted above, this is not a realistic view. To be ready to develop and implement a franchise expansion program that has a reasonable prospect for success (even survival), a business must meet certain criteria and its management must be prepared to follow certain guidelines. If the business has an operating history of several years and operates in more than a single location, these criteria already may have been met, at least to some degree.

The first criteria is a product or service for which there is an established and growing demand, or at least good potential to achieve such demand. A start-up franchisor with a sensational product or service concept is nevertheless at a disadvantage vis-à-vis established franchisors in attempting to sell franchises to high potential franchisees. If the demand for the company's product or service is not expanding relative to business generally, or is little different from the offerings of many other franchisors, its start-up handicap is increased.

It is also important for the company's business to have some degree of distinctiveness.

The more unique or distinctive the business concept (subject, of course, to a proven demand for its products or services), the easier it is to attract franchisees and develop a market for the franchise network's goods and services. A copycat business will have difficulty attracting high potential franchisees. The market for high capability franchisees is increasingly competitive.

Different elements of a franchised business can make it distinctive:

(1) its operating systems,

(2) its products and/or services,

(3) its delivery systems,

(4) its trademarks and trade dress, including a unique feature or symbol that is easily remembered and can be prominently featured in advertising (e.g., McDonald's golden arches), and

(5) its marketing, including both regular advertising and marketing, sponsorships and public relations that generate publicity.

What is the franchise? **A franchise** is the agreement or license between two legally independent parties which gives:

• a person or group of people (franchisee) the right to market a product or service using the trademark or trade name of another business (franchisor);

• the franchisee the right to market a product or service using the operating methods of the franchisor;

• the franchisee the obligation to pay the franchisor fees for these rights;

• the franchisor the obligation to provide rights and support to franchisees.

There are two main types of franchises:

- product distribution
- business format

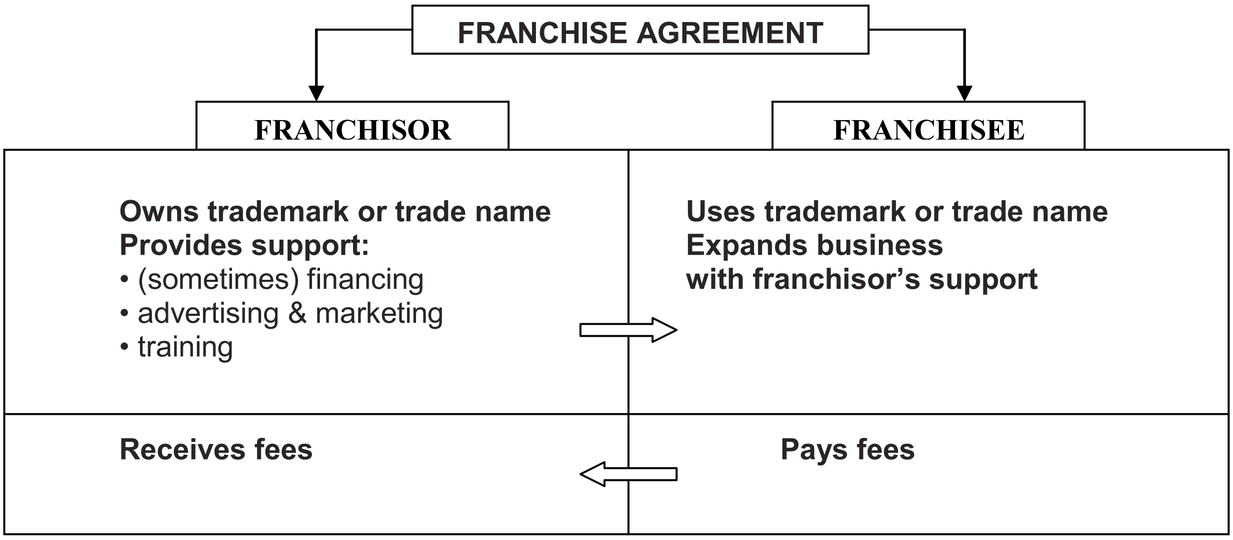

Figure 1. Content of Franchise Agreement.

Product distribution franchises simply sell the franchisor's products and are supplier-dealer relationships.

In product distribution franchising, the franchisor licenses its trademark and logo to the franchisees but typically does not provide them with an entire system for running their business. The industries where you most often find this type of franchising are soft drink distributors, automobile dealers and gas stations.

Although product distribution franchising represents the largest percentage of total retail sales, most franchises available today are business format opportunities.

Business format franchises, on the other hand, not only use a franchisor's product, service and trademark, but also the complete method to conduct the business itself, such as the marketing plan and operations manuals. Business format franchises are the most common type of franchise.

There are the 10 most popular franchising opportunities are in these industries inthe world:

- fast food
- retail
- service
- automotive
- restaurants
- maintenance
- building and construction
- retail—food
- business services
- lodging

Because so many franchisors, industries and range of investments are possible, there are different types of franchise arrangements available to a business owner.

Two types of franchising arrangements:

- single-unit (direct-unit) franchise
- multi-unit franchise:

• area development
• master franchise (sub-franchising)

A **single-unit** (direct-unit) **franchise** is an agreement where the franchisor grants a franchisee the rights to open and operate ONE franchise unit. This is the simplest and most common type of franchise. It is possible, however, for a franchisee to purchase additional single-unit franchises once the original franchise unit begins to prosper. This is then considered a multiple, single-unit relationship.

A **multi-unit franchise** is an agreement where the franchisor grants a franchisee the rights to open and operate MORE THAN ONE unit.

There are two ways a multi-unit franchise can be achieved:

- an area development franchise or
- a master franchise.

Under an **area development franchise**, a franchisee has the right to open more than one unit during a specific time, within a specified area. For example, a franchisee may agree to open 5 units over a five year period in a specified territory.

A **master franchise agreement** gives the franchisee more rights than an area development agreement.

In addition to having the right and obligation to open and operate a certain number of units in a defined area, the master franchisee also has the right to sell franchises to other people within the territory, known as sub-franchises. Therefore, the master franchisee takes over many of the tasks, duties and benefits of the franchisor, such as providing support and training, as well as receiving fees and royalties.

When is a company ready to franchise? Fully tested prototypes of the business are essential. Prototypes test and refine the business concept, products/services and operating system that the franchisor will license to franchisees. They are the models of the business to be franchised. Prototypes should be tested in different types of markets and locations - and for a sufficient time period. The operation of one or more prototypes will afford the prospective franchisor the opportunity to test and refine:

(1) designs, layouts, décor and signage;

(2) products and services;

(3) customer reactions and satisfaction;

(4) equipment and fixtures;

(5) training methods;

(6) advertising and marketing;

(7) job descriptions;

(8) number of employees needed at different times;

(9) required skill levels;

(10) wage levels and benefits; and

(11) other operating characteristics and costs.

Problems will be identified and the prototypes can be modified to test proposed solutions. Such testing of the business concept and operating system in prototypes of the actual business will prepare the company for effective franchising. Using franchisees to debug a theoretical business model is a high risk approach to franchising. The operation of prototypes also enables the business to develop the operating system standards (sometimes called “brand standards”) — the aggregate of the specifications, quality and other standards and operating procedures that will define the network brand and serve as the guide and the legal standards for the franchise relationship. System standards, of course, are not static, and will continue to evolve as the network expands. Nevertheless, it is essential to have the basics of the operating system and standards developed and understood before franchise expansion is launched. Before implementing a franchising program, a company should evaluate what the pilot operations, have shown about the business. Will the products or services satisfy current and probable future consumer needs, be readily adapted to other areas of the country and be salable at projected price levels? Does the business have a significant incidence of repeat customers? Are there proprietary elements of the operating system that cannot be easily duplicated? Can the operating system be effectively communicated in an operations manual? Can managerial and other employees quickly and effectively learn the operating system of the business? Can the operating system and standards be readily teachable to — and implemented by — persons of varying education, ability and experience? Is the design of the outlet significantly flexible to be scaled up or down, or otherwise modified, to fit into the variety of sites that are likely to be available? Are there major financial or operational problems to resolve? And perhaps most importantly, does the business operate profitably and is the return on investment satisfactory? If a company has operated for several years in multiple locations, these outlets will be its prototypes. However, if expansion with franchisees will include difficult types of markets or facilities, additional prototypes may be desirable to test those markets and facilities.

Also the many **advantages and disadvantages of owning a franchise** should be carefully evaluated before deciding to purchase one.

Advantages:

- “Owning a franchise allows you to go into business for yourself, but not by yourself.”
- A franchise provides franchisees with a certain level of independence where they can operate their business.
- A franchise provides an established product or service which already enjoys widespread brandname recognition. This gives the franchisee the benefits of customer awareness which would ordinarily take years to establish.
- A franchise increases your chances of business success because you are associating with proven products and methods.
- Franchises may offer consumers the attraction of a certain level of quality and consistency because it is mandated by the franchise agreement.
- Franchises offer important pre-opening support:
  - site selection
  - design and construction
  - financing (in some cases)
  - training
  - grand-opening program
- Franchises offer ongoing support
  - training
  - national and regional advertising
  - operating procedures and operational assistance

• ongoing supervision and management support
• increased spending power and access to bulk purchasing (in some cases)

Disadvantages:

- The franchisee is not completely independent. Franchisees are required to operate their businesses according to the procedures and restrictions set forth by the franchisor in the franchise agreement. These restrictions usually include the products or services which can be offered, pricing and geographic territory. For some people, this is the most serious disadvantage to becoming a franchisee.
- In addition to the initial franchise fee, franchisees must pay ongoing royalties and advertising fees.
- Franchisees must be careful to balance restrictions and support provided by the franchisor with their own ability to manage their business.
- A damaged, system-wide image can result if other franchisees are performing poorly or the franchisor runs into an unforeseen problem.
- The term (duration) of a franchise agreement is usually limited and the franchisee may have little or no say about the terms of a termination.

How do franchisors approach the franchise relationship today? The basic structure of the franchise relationship, as reflected in franchise agreements, has not significantly changed (most of the changes made by franchisors to their forms of franchise agreements have been the result of judicial and arbitration decisions), but franchisors recognize that there is much more to the relationship than is reflected in the typical franchise agreement. Franchisors increasingly view their franchisees as partners in a joint enterprise.

Most franchisors and franchisees both recognize that they have common goals that outweigh their individual interests. Franchisors understand that franchisees who are not only profitable, but realize a good return on their investment:

(1) acquire additional franchises, helping to grow the network and enhance its competitive position;

(2) reinvest in their business in order to keep them updated and in tune with customer demand;

(3) are generally supportive of the franchisor’s efforts to expand its network and keep its business competitive; and

(4) will pay the franchisor higher fees. It is widely recognized by franchisors that a partnership approach minimizes disputes and litigation.

What is the reason for the current emphasis on service and cooperative relationships?

There are probably several key factors. There has been an enormous growth in the number, size and maturity of franchise networks during the past quarter century, and, consequently, considerable experience gained by franchisors and franchisees — a better understanding of what works and what doesn’t. Many franchisor managers have had management experience in two or more networks and a significant number have also been or currently are franchisees. There has evolved a much greater understanding of:

(1) the drivers of growth and success in franchise networks — strong, cooperative franchise relationships and successful franchisees who reinvest in their businesses and acquire additional franchises; and

(2) of the components of these drivers that successful franchise networks have developed — provide value to franchisees and have a franchising friendly philosophy.

The modern franchise network does not have just two components, a franchisor and its franchisees. There are additional stakeholders, specifically, a wide range of suppliers of goods and services, lenders to the franchisees of a network and customers of franchisee and franchisor operated outlets, and their importance to, and interest in, the network increases as the network expands. Thus, the relationships within a franchise network have impacts on stakeholders beyond the directly involved parties. If the network is to function effectively and expand, those stakeholders must perceive the dynamics of the network as positive and stable; they must be willing to supply, lend to, and buy from network outlets. This fact of the franchise relationship is well understood by franchisors and franchisees. To be sure, there are other factors that influence the willingness of these stakeholders to support a franchise network, but generally positive and stable franchise relationships is certainly a significant influence.

Advertising and Marketing

1. Franchisor Advertising and Marketing

Successful franchisors develop and implement effective advertising and marketing programs to enhance the network brand and the business of their franchisees. Pooling network resources to develop programs and buy advertising and marketing services is a key rationale for the development of a franchise network. Each franchisee acquires access to and the benefits of advertising and marketing programs at a level of professionalism, exposure and impact far beyond its ability as an independent business. Effective advertising is essential for a network's brand to gain recognition and strength vs. competitors. The failure of a network to be competitive is a significant business risk undertaken by a franchisee.

National and regional advertising programs of franchise networks are typically supported by franchisee contributions or fees, customarily a percentage of the franchisee's revenue, but some times a fixed amount, indexed to inflation. Some franchise agreements provide for such contributions or fees to be paid from the inception of the franchise relationship, while other defer the payment until the network has achieved a specific benchmark (e.g., 100 outlets). Practice varies among franchisors with respect to the administration of the advertising function (i.e., in a separate corporation or trust or merely through a separate account on the franchisor's books).

Typically, advertising funds may be spent for the development of advertising and marketing programs, advertising agency fees, various forms of print and other advertising materials, video and radio advertising, public relations services and website development and maintenance.

Franchisors use various methods to track the effectiveness of advertising and marketing themes, materials and media.

Good coordination of national, regional (e.g., advertising coops) and local advertising and marketing can maximize the effect of the available funds. Advertising and marketing at different levels should be complimentary, with each effort enhancing the others. Delivery of a consistent message in all advertising and marketing is important. A franchisor should establish the guidelines for regional and local advertising to assure good coordination.

2. Franchisee Advertising and Marketing

Many franchise networks have regional advertising cooperatives to which their franchisees are required to contribute. Each cooperative establishes the rate of contribution, up to a limit prescribed in each franchisee's franchise agreement. The territory of each cooperative is usually determined by the franchisor and all franchisees located within that territory are required to participate. Franchisor operated stores belong to the cooperative designated for the territory in which they are located. A franchisor representative may be a member of the governing board of each cooperative. Regional advertising cooperatives generally focus on regional (e.g., metropolitan area) advertising and marketing, which includes local newspapers and magazines, television and radio, billboards, special events and other regional advertising and marketing venues.

Franchisors assist their franchisees with local marketing by developing a local outlet marketing plan designed to support and compliment national and regional advertising and marketing. Franchise agreements typically obligate the franchisee to spend a percentage of its revenues or a specific amount (which may be indexed to inflation or periodically increased by fixed increments) for local advertising and marketing, including local media, classified telephone directory advertising, direct mail, bag stuffers, promotions and the like. Local advertising expenditure requirements may be reduced when national advertising contributions or fees, and/or regional cooperative advertising contributions, become payable or are increased.

Franchisors include comprehensive local marketing instruction in the franchisor's training program and typically design and assist franchisees to implement effective grand opening promotional marketing. Franchisors also develop a wide variety of print and other media materials and offer such materials to their franchisees directly or through independent suppliers with whom the franchisor and its franchisees have successful relationships.

Successful franchisors furnish advice and guidance on local advertising and marketing, counseling franchisees with respect to what has and has not worked, and/or what is and is not cost effective. Franchisors also arrange for successful franchisees to offer advice and guidance to other franchisees. Franchisees should be encouraged and guided to become involved in their communities through sponsorships of sport teams and civic events and civic and charitable involvement.

Franchise networks are expanding the use of loyalty cards — smart cards — that simplify buying the franchise network goods or services, offer rewards to the customer, identify customers and gather data on customer buying habits. Franchise agreements should require franchisees to participate in marketing programs such as network specific, smart cards (e.g., by promoting and accepting the cards). Loyalty cards that have a stored value function require a mechanism for reimbursement of the franchisee who accepts as payment for goods or services a card sold by another franchisee.

At present time in Russian Federation already are more then 3000 franchised outlets under around 300 brands including practically 100 domestic brands. Every year their number is increasing for more then 20%.

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