



# Chapter 15

## **Franchising**

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# Chapter Objectives

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1. Explain franchising and how it differs from other forms of business ownership.
2. Describe the difference between a product and trademark franchise and a business format franchise.
3. Explain the differences among an individual franchise agreement, an area franchise agreement, and a master franchise agreement.
4. Describe the advantages of establishing a franchise system as a means of firm growth.

# Chapter Objectives

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5. Identify the rules of thumb for determining when franchising is an appropriate form of growth for a particular business.
6. Discuss the factors to consider in determining if owning a franchise is a good fit for a particular person.
7. Identify the costs associated with buying a franchise.
8. Discuss the advantages and disadvantages of buying a franchise.

# Chapter Objectives

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9. Identify the common mistakes franchise buyers make.
10. Describe the purpose of the Franchise Disclosure Document.

# Introduction to Franchising

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- Introduction
  - Franchising is growing in popularity.
  - In 2007 (the most recent year statistics are available), nearly 766,000 franchise outlets were operating in the U.S.
- History
  - The word “franchise” comes from an old dialect of French and means privilege or freedom.
  - Many of the most popular franchises, including KFC (1952), McDonald’s (1955), and H&R Block (1958) started as early as the 1950s.

# What is Franchising?

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- Franchising
  - Franchising is a form of business organization in which a firm that already has a successful product or service (franchisor) licenses its trademark and method of doing business to another business or individual (franchisee) in exchange for a franchise fee and an ongoing royalty payment.
  - Some franchisors are established firms (like McDonald's) while others are first-time enterprises being launched by entrepreneurs.

# Two Types of Franchise Systems

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- Product and Trademark Franchise
  - An arrangement under which the franchisor grants to the franchisee the right to buy its products and use its trade name.
  - This approach typically connects a single manufacturer with a network of dealers or distributors.
    - For example, General Motors has established a network of dealers that sell GM cars and use the GM trademark in their advertising and promotions.
    - Other examples of product and trademark franchisors include agricultural machinery dealers, soft drink bottlers, and beer distributorships.

# Two Types of Franchise Systems

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- **Business Format Franchise**
  - An arrangement under which the franchisor provides a formula for doing business to the franchisee along with training, advertising, and other forms of assistance.
  - Fast-food restaurants, convenience stores, and motels are well-known examples of business format franchises.
    - Business format franchises are by far the most popular form of franchising, particularly for entrepreneurial firms.

# Top 10 Business Lines in Which Business Format Franchises Operate

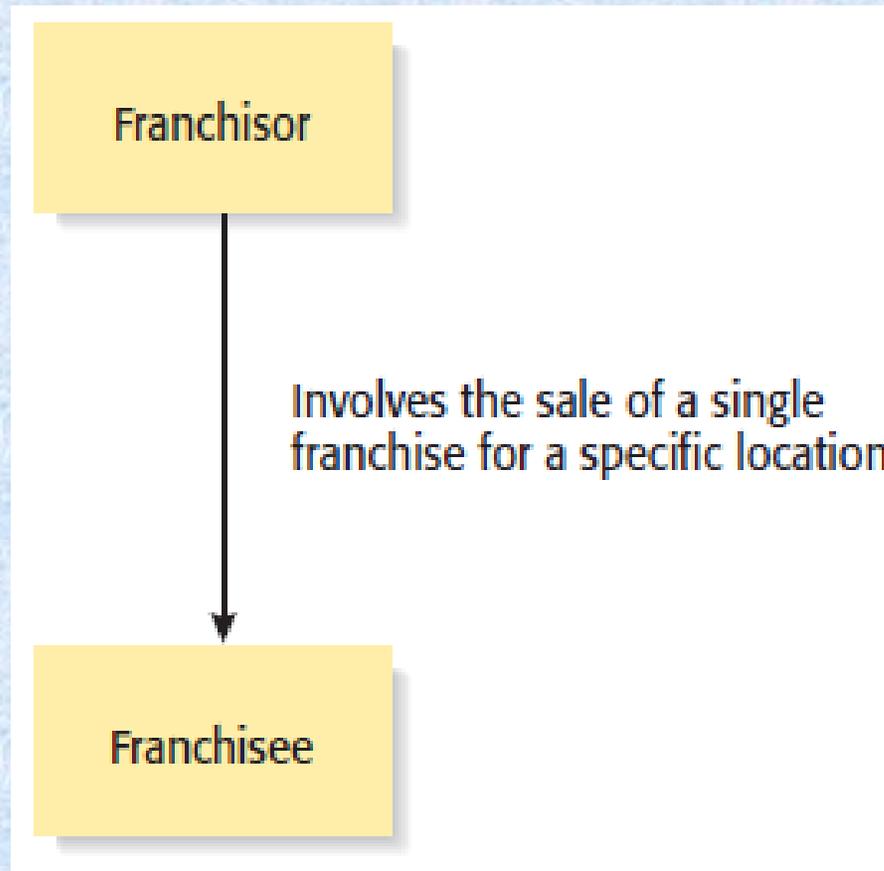
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1. Automotive
2. Commercial and residential services
3. Quick service restaurants
4. Table/Full-service restaurants
5. Retail food
6. Lodging
7. Real Estate
8. Retail products and services
9. Business services
10. Personal services

# Types of Franchise Agreements

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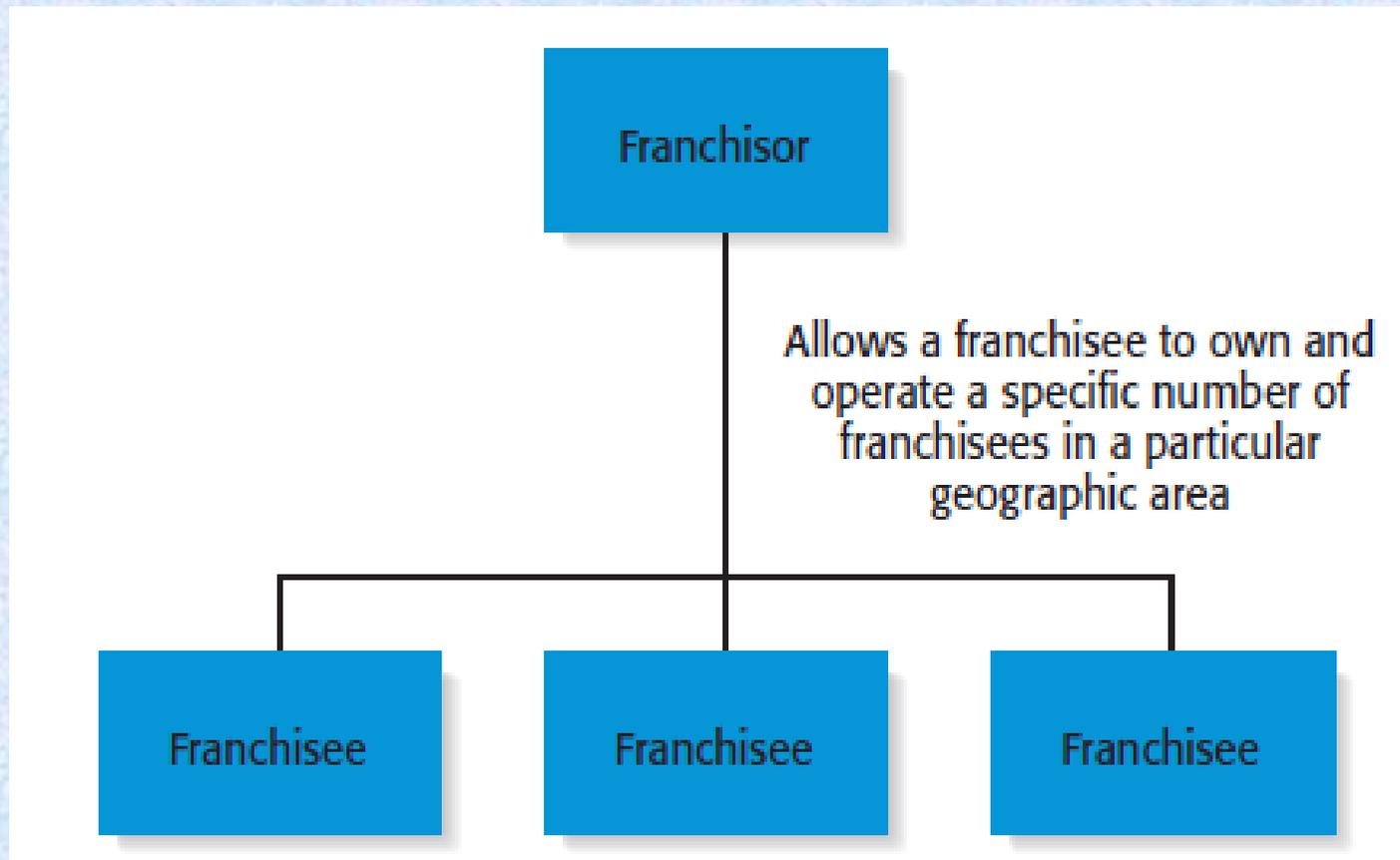
## Individual Franchise Agreement



# Types of Franchise Agreements

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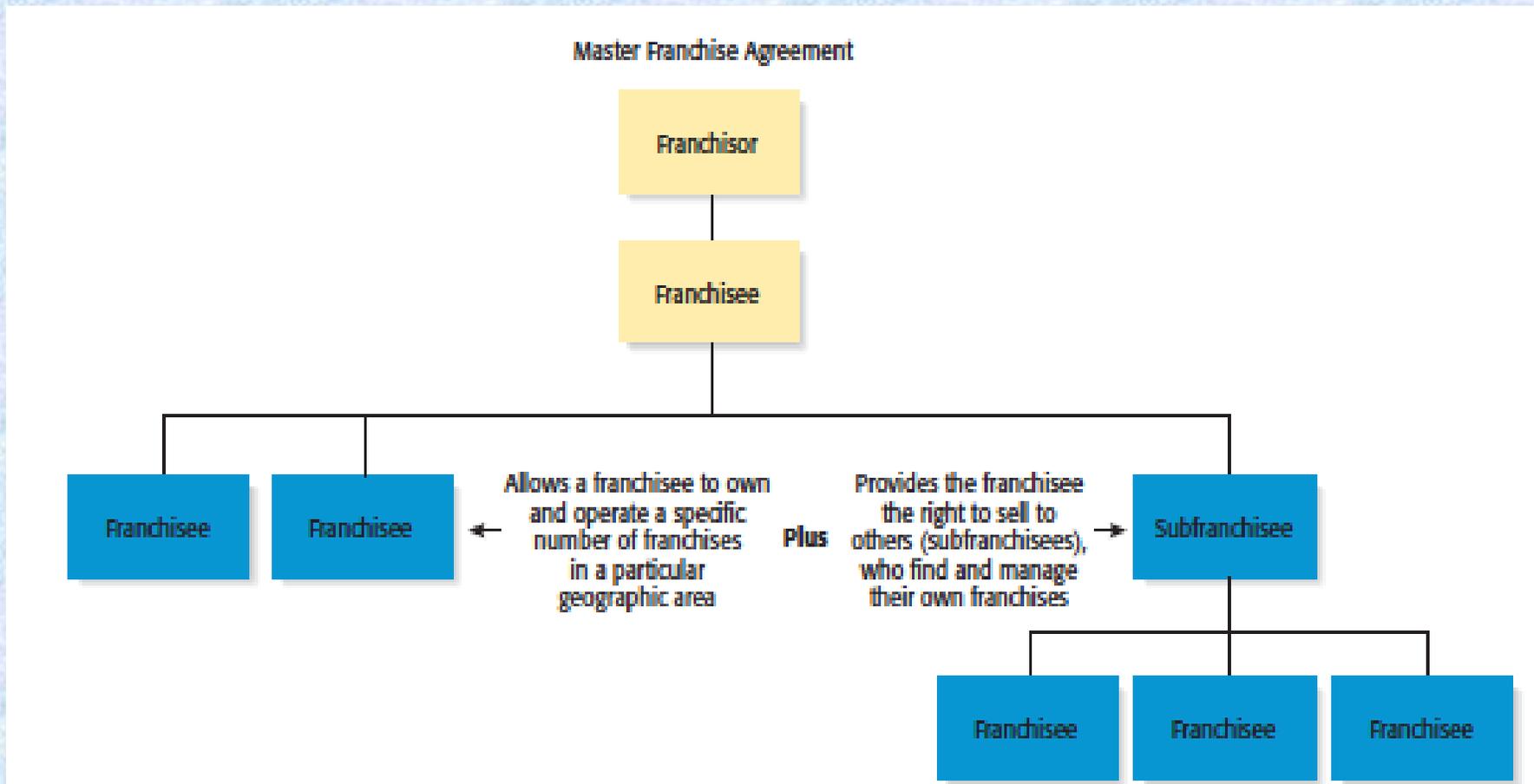
## Area Franchise Agreement



# Types of Franchise Agreements

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## Master Franchise Agreement



# When to Franchise?

From the Franchisor's Point of View

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- **Approach Franchising With Caution and Care**
  - Establishing a franchise system should be approached carefully and deliberately.
  - Franchising is a complicated business endeavor, and an entrepreneur must look closely at all its aspects before deciding to franchise.
- **Regulations**
  - An entrepreneur should also be aware that over the years a number of fraudulent franchise organizations have come and gone and have left financially ruined franchise owners behind.

# When to Franchise?

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- When Is Franchising Most Appropriate?
  - Franchising is most appropriate when a firm has a strong or potentially strong trademark, a well-designed business method, and a desire to grow.
  - A franchise system will ultimately fail if the franchisee's brand doesn't add value for customers and its business method is flawed or poorly developed.

# Nine Steps in Setting Up a Franchise System



# Qualities to Look for in Prospective Franchisees

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- Good work ethic
- Ability to follow instructions
- Ability to operate with minimal supervision
- Team oriented
- Experience in the industry in which the franchise competes
- Adequate financial resources and good credit history
- Ability to make suggestions without becoming confrontational or upset if the suggestions are not adopted
- Represents the franchisor in a positive manner

# Ways Franchisors Can Develop the Potential of Their Franchisees

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- Provide mentoring that supersedes routine training.
- Keep operating manuals up-to-date.
- Keep products, services, and business systems up to date.
- Solicit input from franchisees to reinforce their importance in the larger system.
- Encourage franchisees to develop a franchise association.
- Maintain the franchise system's integrity.

# Advantages and Disadvantages of Franchising as a Method of Business Expansion

## Advantages

- Rapid, low-cost market expansion
- Income from franchise fees and royalties
- Franchisee motivation
- Access to ideas and suggestions
- Cost savings
- Increased buying power

## Disadvantages

- Profit sharing
- Loss of control
- Friction with franchisees
- Managing growth
- Differences in required business skills
- Legal expenses

# Buying a Franchise

From the Franchisee's Point of View

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- Buying a Franchise
  - Purchasing a franchise is an important business decision involving a substantial financial commitment.
  - Potential franchise owners should strive to be as well informed as possible before purchasing a franchise and should be aware that it is often legally and financially difficult to exit a franchise relationship.

# Buying a Franchise

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Answering the following questions will help determine if franchising is right for you

- Are you willing to take orders? Franchises are typically very particular about how outlets operate.
- Are you willing to be part of a franchise “system” rather than be an independent businessperson?
- How will you react if you make a suggestion to your franchisor and your suggestion is rejected?
- What are you looking for in a business? How hard do you want to work?

# Buying a Franchise

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Answering the following questions will help determine if franchising is right for you

- How willing are you to put your money at risk? How will you feel if your business is operating at a net loss but you will have to pay royalties on your gross income?

# The Costs Involved With Buying a Franchise

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- Initial Franchise Fee
  - The initial fee varies depending on the franchisor.
- Capital Requirements
  - The costs vary but may include the cost of buying real estate, the cost of putting up a building, the purchase of inventory, and the cost of obtaining a business license.
- Continuing Royalty Payment
  - Is usually around 5% of monthly gross income.

# The Costs Involved With Buying a Franchise

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- Advertising Fees
  - Franchisees are often required to pay into a national or regional advertising fund.
- Other Fees
  - Other fees may be charged for various activities, including:
    - Training additional staff
    - Providing management expertise when needed
    - Providing computer assistance
    - Providing a host of other items or support services

# The Costs Involved With Buying a Franchise

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**TABLE 15.4 INITIAL COSTS TO THE FRANCHISEE OF A SAMPLE OF FRANCHISE ORGANIZATIONS**

Franchise Organization	Year Started Franchising	Company-Owned Units	Franchised Units	Franchise Fee	Ongoing Royalty Fee	Total Initial Investment
Bark Busters	1994	4	364	\$37,500	8%	\$69,100–\$97,100
Comfort Keepers	1999	0	660	\$38,500	3%–5%	\$58,410–85,280
Game Truck	2008	1	25	varies	7%	\$115,250–\$320,500
Huntington Learning Centers	1985	33	318	\$43,000	8%	\$162,000–\$257,600
KFC	1952	4,281	11,983	\$45,000	5%	\$1.3 million–\$2.4 million
McDonald's	1955	6,399	26,338	\$45,000	varies	\$1 million–1.9 million
Papa John's Pizza	1986	620	2,909	\$25,000	5%	\$98,823–\$528,123
School of Rock	2005	21	36	\$49,500	8%	\$115,650–\$400,400
Subway	1974	0	34,134	\$15,000	8%	\$84,300–\$258,300
Wild Birds Unlimited	1983	0	274	\$18,000	4%	\$92,157–\$140,736

# Advantages and Disadvantages of Buying a Franchise

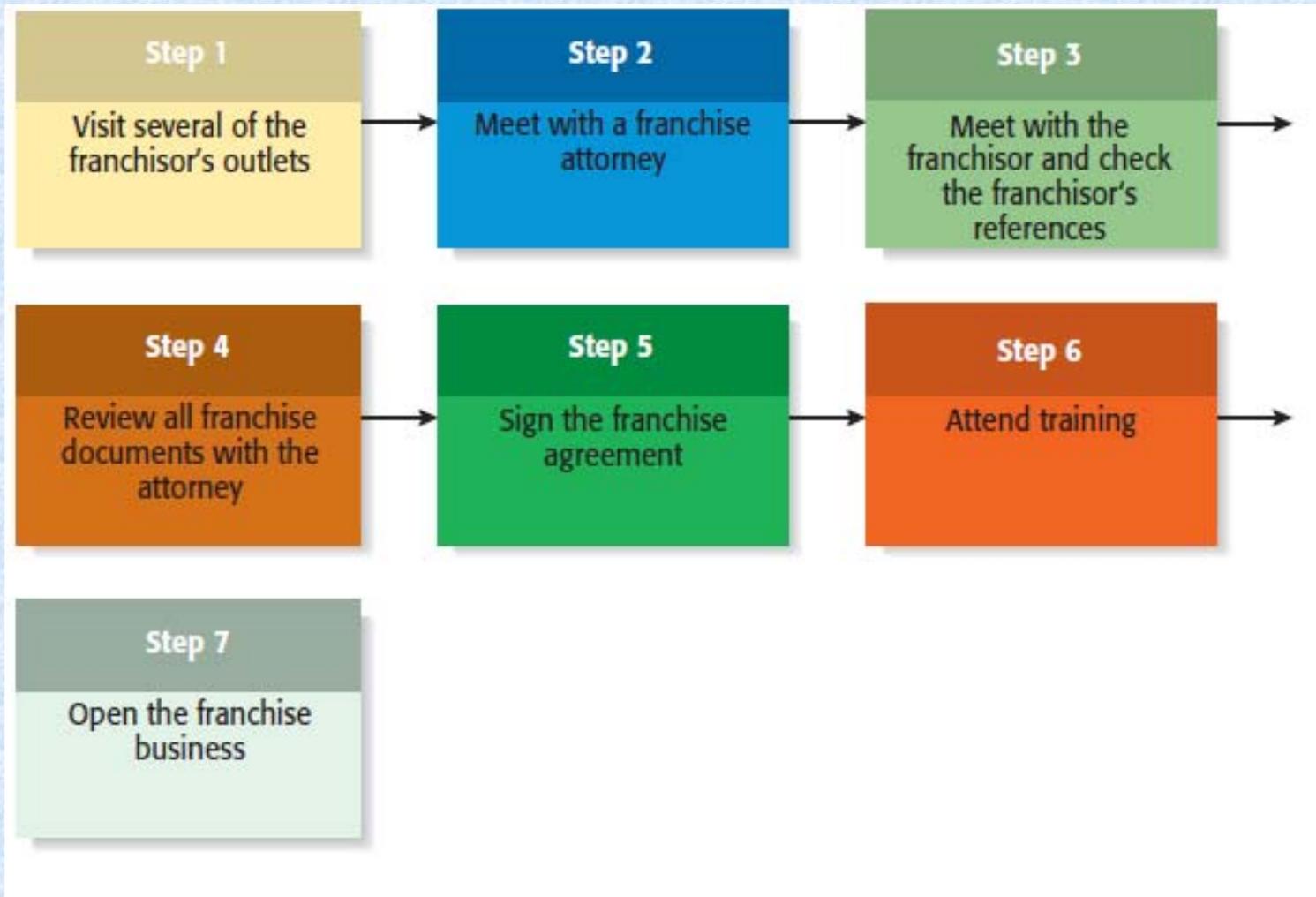
## Advantages

- A proven product or service within an established market
- An established trademark or business system
- Franchisor's training, technical expertise, and managerial expertise
- An established marketing network
- Franchisor ongoing support
- Availability of financing
- Potential for business growth

## Disadvantages

- Cost of the franchise
- Restrictions on creativity
- Duration and nature of the commitment
- Risk of fraud, misunderstandings, or lack of franchisor commitment
- Problems of termination or transfer
- Poor performance on the part of other franchisees
- Potential for failure

# Seven Steps in Purchasing a Franchise



# Watch Out! Common Misconceptions About Franchising

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- Franchising is a safe investment.
- A strong industry ensures franchise success.
- A franchise is a “proven” business system.
- There is no need to hire a franchise attorney or an accountant.
- The best systems grow rapidly and it is best to be part of a rapid-growth system.
- I can operate my franchise outlet for less than the franchisor predicts.
- The franchisor is a nice person—he’ll help me out if I need it.

# Legal Aspects of the Franchise Relationship

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- Federal Rules and Regulations

- The offer and sale of a franchise are regulated at the federal level.
  - According to Federal Trade Commission (FTC) rule 436, franchisors must furnish potential franchisees with written disclosures that provide information about the franchisor, the franchised business, and the franchise relationship.
  - In most cases, the disclosures are made through a lengthy document referred to as the Franchisor Disclosure Document (FDD).
  - The FDD contains 23 categories of information that give a prospective franchisee a broad base of information about the background and financial health of the franchisor.

# More About Franchising

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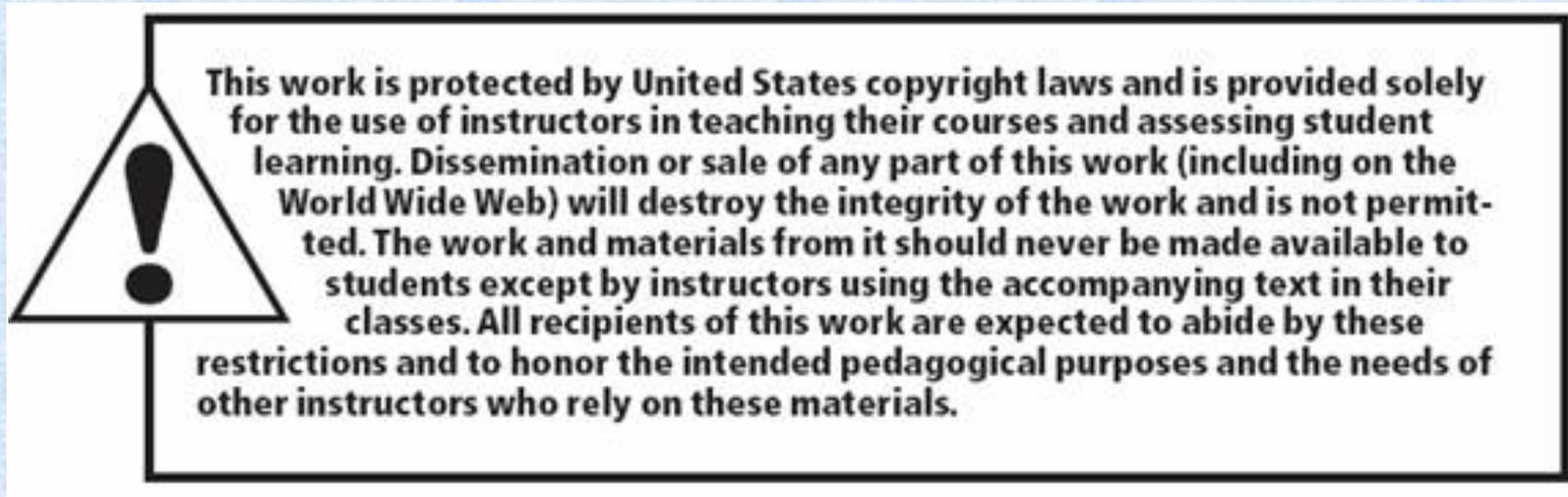
- Franchise Ethics
  - The majority of franchisors and franchisees are highly ethical.
  - There are certain features of franchising, however, that make it subject to ethical abuse. These features are as follows:
    - The get-rich-quick mentality
    - The false assumption that buying a franchise is a guarantee of business success
    - Conflicts of interest between franchisors and franchisees

# More About Franchising

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- International Franchising
  - International opportunities for franchising are becoming more prevalent for the following two reasons:
    - The markets for certain franchised products in the U.S. have become saturated (i.e., fast food).
    - The trend toward globalization continues.
  - Steps to take before buying a franchise overseas:
    - Consider the value of the franchisor's name in the foreign country.
    - Get a good lawyer.
    - Determine whether the product or service is saleable in the foreign country.
    - Find out how much training and support you will receive from the franchisor.



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