"ISSUES TO CONSIDER ON FRANCHISING YOUR BUSINESS"

"LINKING ENTERPRISE WITH OPPORTUNITY"

A GUIDE PREPARED FOR THE IRISH FRANCHISE ASSOCIATION

BY

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Guide for Potential Franchisors

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Guide for Potential Franchisors

Introduction

Business Format Franchising is a method of business development which is widely used, particularly in the service sector, to enable businesses to expand rapidly.

Rather than go through a process of organic growth, and expanding the number of outlets through which a company would operate, an increasing number of companies are becoming franchisors, but it should only be considered as *one* possible option for the expansion of a business. In some instances franchising will offer significant advantages to a company in developing its business; in other instances expansion through Business Format Franchising would not be appropriate at all.

What is franchising?

The term franchising is used very loosely to describe a method of business expansion in which the franchisor grants franchisees certain rights which enable the franchisees to operate their own businesses, duplicating the system operated by the franchisor. In this general sense, the following would be examples of franchises:-

- Rights to sell products bearing the franchisors name, example motor dealerships would fall into this category.
- Rights to provide a service in a specified area: commercial television stations or radio stations would be an example of this.
- Rights to use celebreties names and merchandising, as in the sale of sport goods.

These examples would be well know and are understood by the business community generally, even if they are not being referred to as franchisors. However, the focus of this talk will be in relation to the question of Business Format Franchising.

This guide will be set out in two main parts, the first containing some factual information which is intended to provide help in deciding whether or not franchising would provide an attractive form of business development. The second part will help a company to decide whether franchising will be appropriate for its own circumstances. This guide is not intended as it do itself kit on how to become a franchisor, but should help companies to make a sound preliminary appraisal of whether they wish to consider franchising their business. If companies decide that Business Format Franchising is an option worth considering then the next stage is to commit the time and resources to examining the potential of franchising, in depth, with reference to the company's own particular circumstances. At this stage professional advice should be sought and/or the services of someone who has direct experience of franchising obtained.

In addition to this guide, I have also prepared another document which is available through the Irish Franchise Association website at www.irishfranchiseassociation.com, on "How to Franchise your Business", which is a 40 page guide on the issues that will have to be considered, once the preliminary appraisal has been completed.

ASSESSING YOUR BUSINESS FOR FRANCHISING

This section presents a franchise process which *could* be followed by a company if it were interested in franchising. The purpose of this is to take factual information and present it in a form which will help a company to assess the suitability of franchising from their own business circumstances. Its starting point is a review of business objectives and the subsequent sections deal with:-

- the market for the goods or services
- the technical feasibility of using franchising; and
- costs and returns of franchising, including establishment and operating costs

You should also consider these points in the light of your own business circumstances, and then try to answer the following questions:-

- does franchising enable your company to achieve its business objectives?
- is there is a market for your products?
- can the business be established as a franchise?
- does franchising make commercial sense?
- does franchising compare favourably with other options for achieving your company objectives?

If the answers to these questions are yes or if action can be taken to make the answer yes, companies interested in franchising could proceed to the next step which is to commit resources to examining the potential of franchising in depth. This guide will hopefully help you to undertake a preliminary appraisal of your business but further assessment is required to enable the company to reach a soundly based decision on whether to not to franchise. Depending on the business and the resources available this could mean employing one or more of the following:

- a market research consultant,
- a franchise consultant,
- an accountant with experience in dealing with franchise businesses,
- design consultants,
- a solicitor with experience in dealing with franchise businesses.

Following a positive decision to franchise, you should follow the steps outlines in a later section, starting with the development of the business, and working towards establishing a pilot in the business.

It should again be stressed that this guide is not a workbook and the aim of this to assist companies to decide whether it is worthwhile committing time and money to a more detailed appraisal of franchising.

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Business Format Franchising

Business Format Franchising is a particular form of franchising in which the franchisor grants right to a franchisee to operate a complete tested and proved business system or format, to the franchisees, using the franchisor's business systems, name, intellectual property rights etc. Franchisees pay for these rights and enter into a legal contract with the franchisor governing their use.

Business Format Franchising brings together the management, production / delivery and marketing expertise of the franchisor with the capital, motivation and capability of the franchisee. The development of a franchised business is therefore to the mutual benefit for both the franchisor and the franchisee. This reflects the motto of the Irish Franchise Association, "Linking Enterprise with Opportunity".

It is the strong relationship between the franchisor and the franchisee, with the success of one being dependent upon the performance of the other, which is the distinguishing feature of Business Format Franchising. The relationship is close and continuing, with the franchisor providing support to the franchisee to ensure that both individual outlets and the business format as a whole, develops and succeeds in the longer term. A franchise business will only succeed if the franchisor behaves ethically and the franchisees are competent, and adhere to the key features of ethical franchising as observed by the Irish Franchise Association for example. In a Business Format Franchise, the franchisor

- allows franchisees to use the franchisor's trading names,
- allows franchisees to use the franchisor's logos,
- allows franchisees to use the franchisor's intellectual property,
- allows franchisees to use the franchisor's "know how",
- allows franchisees to use the franchisor's business style and format
- assists the franchisee to establish their own franchise business to the predetermined format; and
- provides continuing and ongoing support to enable the franchisee to operate their business successfully.

Suitable activities for Business Format Franchising.

Business Format Franchising involved business expansion through the replication of business outlets which are owed by franchisees. Therefore the activity to be franchised must be one which is capable of being carried out in a number of geographically dispersed units. The activity should also be one in which the day to day decision making can be effectively undertaken at the level of each individual unit. Franchising is particularly well suited to businesses in which sales of goods or services are through retail or wholesale outlets, particularly where a promotion can create a quality imagine and the product or service can be standardized with a few technical skills required to operate individual outlets

Business Format Franchising has also been used for purely manufacturing activities, but there are some franchises with a large production component, such as instant print franchises. It has though, been used successfully by manufacturers as a means establishing dedicated sales outlets.

The Development of Franchising

Some of the key elements of Business Format Franchising have existed for over a century, the *"tied house"* system used by breweries being an early example in Britain. Its use as a form of business development was developed in the United States where its use grew rapidly from the late 1940s. The use of franchising spread to other countries, including Canada, Japan, France and Germany during the 1970s and the pattern then developed throughout the rest of the EU. Franchising in Ireland has seen a considerable growth in recent years and the figures can be seen in the franchise survey which is available from the Irish Franchise Association website www.irishfranchiseassociation.com, as a PDF download document. The 2001 survey is on the site at the moment, and over the course of next few weeks, the 2004 survey will be available. This will also give some indication of the diversity of businesses which have been franchised.

Key Elements of Franchising

Franchising is a contractual relationship, since it involves the licensing to the franchisee of rights to use the business format owned by the franchisor. Examination of what is covered by the contract therefore provides an explanation of the content of the franchise relationship. The contract is the basis of the relationship, but it does not explain why the franchise relationship works in practice. The why is best answered by looking at the benefits to the franchisor and the franchisee and the incentives which make the relationship work.

The Franchise Contract

The contract is the legal basis of the franchise relationship and has therefore to cover aspect of the business to the franchised, including the franchisor's obligations to the franchisee, and the franchisee's rights and duties,

- **Franchisor's obligations**

The franchisor's obligations to the franchisee will include

- training to produce the products or service,
- training in operating the business,
- start up help,
- selection of premises,
- operating manuals,
- financial systems,
- ongoing assistance and troubleshooting,
- marketing and advertising.

- **Franchisee's obligations**

By signing the contract the franchisee obtains the right to use the franchisor's business format. The terms of the use of the licence will be specified in the contract including

- what is and what is not to be sold or provided in the course of the business,

- adherence to franchisor's methods and formula,
- secrecy regarding any process or formula,
- performance standards regarding supply of good and services,
- use of the franchisor's business systems,
- use of advertising displays and other materials,
- condition of premises including requirements to improve and refurbish.
- sourcing of inputs, which maybe limited to those supplied by the franchisor or approved by the franchisor,
- payments to be made by the franchise to the franchisor.

- **Other Terms.**

As with any contract of this type there will also be specified :

- the duration of the contract,
- the terms and condition for renewal,
- the conditions under which the contract maybe terminated,
- provisions for settlement of disputes,
- proper law governing the contract,
- post termination consequences and non competition,

In addition, the franchisee may own the franchised outlet and there would be a provision for the sale or assignment of the franchise on the death or retirement of the franchisee, and the contract will state the conditions for the sale of the franchise. The franchisor will exercise strict control over the selection of the purchaser of the franchise, and will have to satisfy the franchisor's normal requirements for franchisees. The franchise contract will have to be very specific and thorough as it sets out the franchisee's rights to earn his liveliness in the business in which his life savings maybe invested.

Why Franchising Works

There are two basic reasons why franchising works in practice:-

- first, there are important advantages for both companies and individuals who become franchisors and franchisees; and
- second, once engaged in franchising there are inherent incentives on both sides of the relationship to make it actually work. The ongoing system works to the benefit of both.

The Benefits for Franchisors

For a small company with a very good idea for a new service, the options for expansion may very often be limited as

- there maybe insufficient capital to sustain a programme of opening its own further outlets,
- if it remains local the potential of the idea will not be exploited fully,
- in time other firms will begin to offer something similar and the advantage of being first in the marketplace may be lost,

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From the point of view of potential franchisees, there maybe clear advantages to taking a franchise rather than trying to establish a similar or competing business.

- the franchisee does not have to come up with a new idea, someone else will have had it and tested it first, and essentially, they will be buying the benefit of the mistakes made by the franchisor and the learning curve experienced by the franchisor,
- larger well established franchise operations will often have national advertising campaigns under a trading name, which would benefit the franchisee and its operations,
- good franchisors, (such as Irish Franchise Association members), will offer comprehensive training programmes in all the business skills required,
- good franchisors can also help to secure funding for the investment by franchisees as well as discounted bulk buy supplies for outlets when in operation,
- if aware that someone is running a franchise customers will also understand that they will be offering the best possible value for money and service, although they maybe running their own show, as a part of a much larger organisation.

The Attractions for Franchisees

From the franchisor's point of view the following are some of the key reasons for pursuing the franchising option. To understand the franchising system, potential franchisors should also understand the benefit for franchisees which in a good franchise are

- a tried tested and business concept,
- training and operations systems and manuals,
- operating systems and manuals,
- assistance in setting up the business,
- continuing / ongoing support.

For the franchisee, a good franchise can overcome many of the problems frequently experienced on becoming self employed. When recruiting franchisees it is important to realise that demand exists for this form of self employment and that a good franchise can represent a marketable package.

Incentives in Franchising

For the franchisor the main incentive arises from the way in which the franchisor's income is structured. The franchisor's income comprises an initial fee, and ongoing management services fees. Ethical franchisors earn only a small proportion of their income from initial fees, the great majority of their income being generated by a fee earned as a proportion of ongoing franchise sales. The franchisor therefore has a major incentive in ensuring that the franchisee's business performs well. The franchisor also has an incentive to establish more outlets, to earn initial fees but primarily to have a larger base on which to earn continuing fees. In order to be able to recruit new franchisees a franchisor has to be able to demonstrate that existing franchises are successful.

For the franchisee, the incentives in franchising are both financial and psychological. The financial incentive is simply that the franchisee in a good franchise should be earning a relatively high return through annual profits and an increasing value on the outlet. These are directly dependent on the performance of the franchised outlet. The psychological incentive to continuing in the franchise relationship is that franchisees are usually the type of people who would not necessarily go into business entirely by themselves and are attracted by the security of having the franchisor's services, system, and support.

Low Capital Investment.

By franchising, the company can ensure that the ideas are more fully and more rapidly exploited, without the company itself having to raise the necessary capital to establish company owned outlets. One of the major benefits to potential franchisors is the relatively low level of capital required compared to expansion by company owned outlets.

For the larger company the ability to expand from a relatively low capital base may not be the most significant benefit. The attractiveness of franchising is more likely to be efficiency gains with an increased market presence. The benefits will depend on the development strategy of the company, whether it has decided to:

- establish a new line of business,
- establish dedicated sales outlets for existing/new products; or
- rationalize its existing sales and distribution systems.

Although efficiency and market development benefits are more likely to be reached by large companies, they are also applicable to smaller companies.

Efficiency

Many companies adopt franchising as a way of using their management resources more efficiently. These companies do not wish to come involved in the costs and problems of the day to day management of sales outlets, preferring to concentrate on their core business, perhaps that of manufacturing. Managing a franchise network requires relatively fewer people then managing a large mostly outlet business operation. The day to day decision making is devolved to the franchisee, operating in accordance with the franchisor's manuals and systems and predetermined standards. Management resources are still required in order to franchise successfully. But these resources are used primarily in strategic development and providing continuing support to franchisees. Some large, vertically integrated companies, with both manufacturing operations and their own retail or wholesale outlets, have converted their outlets to franchises, in order to divest themselves of the day to day management problems of company owned outlets. However, conversion to franchising will only work where the company can benefit from reduced administrative overheads or where the performance of individual outlets will improve by becoming franchised rather than managed outlets.

Conversion Franchising

A recent phenomenon in Ireland has been the concept of what is called conversion franchising. This is where an existing business converts to a franchise operation. An example would be Sherry Fitzgerald where existing auctioneers converted businesses from their own stand alone businesses to become part of the Sherry Fitzgerald franchise network. Douglas Newman Good are now following suit. This in itself is a simple illustration of the principle that a franchise system can be more attractive than a non franchise system.

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Market Development

A company may decide to franchise because of the benefits of achieving increased market penetration through the ability to expand rapidly and to use the motivation of individual franchisees to generate sales. Manufacturers, for example, can establish dedicated outlets without having to become directly involved in managing a chain of retail outlets, thereby reducing overheads. Companies establishing a new line of business may decide that franchising provides benefits for that business.

The Drawbacks in Franchising

There are aspects to franchising which some companies may consider to be drawbacks. As with the advantages, these must be assessed in terms of each company's business policy and circumstances. There are four drawbacks namely

- ownership,
- management and control,
- profit,
- cash flow.

Ownership

In Business Format Franchising the franchisor owns the right to the franchised format, but the franchisees own the franchise outlets. The franchisor builds equity by developing a successful franchise, but may have very few physical assets. The value of the business depends on the quality of the business idea, the returns from the franchisees, and the good will developed. The franchisee builds up equity in the franchised outlets; the franchisor does not have any financial share in the franchisee's business and does not participate in his or her equity.

Management and Control

The franchise relationship can break down even where the franchisor behaves ethically and competently. Problems can arise after a few years where franchisees start to feel more independent and such problems can include

- pressure from franchisees for changes in the business.
- resentment over the payment of continuing fees, due inter alia to the "what am I paying for" view,
- development of *"us and them"* relationships and the breakdown of team spirit and loyalty and trust.

A good and ongoing franchise system, will have built in measures to ensure that these problems do not arise in the first instance. In most businesses the right to control arises through the right of ownership. In franchising, control is ultimately achieved through enforcement of the franchise contract. This is seen by some franchisors as a last resort.

In practice franchisors seek to achieve control through other means, including selecting the right people as franchisees in the first instance and by adopting a management status suited to this type of business relationship. The management style required involves persuasion, exhortation and encouragement, assistance and support, and advices given from one business person to another independent business person, which is not the same as giving orders to a paid manager in a company owned outfit. This style of management may be seen as a disadvantage, particularly if the existing management team is not used to this way of operating.

A further aspect of management concerns disclosure of information. Since the franchisee in one sense is an investor in companies which offer franchises, franchisors must accept the need to disclose information to potential franchisees which they might not normally provide to employees. There should be an openness in relation to the costs and revenue and profit bases of the franchisor.

The level of profit from a franchised outlet will usually be less than that of a company owed outlet, because, in effect the profit is being shared. There has to be a profit for the franchisee. The rate of return will however be high, because the capital employed by the franchisor is relatively low and the franchisor does not have to invest capital in the franchised outlets. Where companies have the capital available to open company owned outlet franchising maybe unattractive as the absolute level of profits generated from each outlet will probably be lower as profits are shared between the franchisee and the franchisor. A direct comparison of the profit ability and expansion through franchised or company owned outlets can be made through a financial appraisal. I will refer to this again later.

Cash Flow

One of the major misconceptions about franchising is that it requires little capital. In fact considerable investment is required in order to pilot the franchise, develop the package, and recruit and train franchisees, and also to recruit and put in place a franchise service manager. We will look at this in some detail later. All of these costs are incurred before any income is received either in the form of franchise fees or management services fees. A franchisor may earn low returns until the number of franchisees expands and the franchisees begin to build up their sales. The franchisor therefore requires sufficient working capital to continue in business until these returns are increased to the franchisor's breakeven point.

STAGES IN BECOMING A FRANCHISOR

FRANCHISING IN ACTION:

The first and second sections have presented an overview of Franchising and I have described the content of the Franchise Contract and I have set out the main benefits for the Franchisor and Franchisees in using Franchising. In this section the aim is to present a much detailed description of what it means to be a Franchisor by looking at:-

- The steps involved in developing a Franchise.
- How the Franchisor develops and operates the Franchise network once it is established.

BECOMING A FRANCHISOR:

There are five stages in becoming a Franchisor:

- Conception of the business idea.
- The planning stage.
- The pilot stage.
- The implementation stage.
- The Franchise launch.

THE BUSINESS IDEA:

The concept or the business idea is a starting point and is self-explanatory in that any company thinking about Franchising requires either a new business idea or to be operating an existing business and must have appropriate objectives such as expansion or promotion of efficiency.

THE PLANNING STAGE:

In the planning stage companies must examine:-

- The market potential of the business concept.
- The feasibility of Franchising.
- The commercial potential, including resources and returns.

Since Franchising is only one option for business expansion, companies should also examine other possibilities in the planning stage. Even if the business being considered has been long established as a company owned chain, the planning stage is still very important to determine whether it could be operated successfully by Franchisees. At the end of the planning stage the company will take the decision whether or not to go ahead with the Franchise. If the decision is positive the company will then proceed to the pilot stage.

THE PILOT STAGE:

In the pilot stage the company will develop the concept further and in detail. Using this concept, it will first establish and operate a pilot version of the business to be franchised. The pilot itself is essential to test and to refine the business in a practical working environment. The pilot can be expensive, as it involves establishing a new outlet in the case of a company developing a brand new business idea, or the re-designing of an existing outlet if the company is to Franchise an existing concept.

A pilot operation is essential in the method of Franchising. It is also sound business sense as it provides the opportunity to experiment and acts as the test base for the training business systems and manuals. Essentially, this shows whether the proof is in the pudding.

THE IMPLEMENTATION STAGE:

In this phase the company will:-

- Finalise the Franchise format.

- Develop the prospectus which will be offered to Franchisees.
- Prepare the Contract.
- Set up initial training and Franchise selection procedures.
- Decide on locations and find premises.
- Promote the Franchise.
- Recruit the first Franchisees.

As with the pilot the implementation stage should not be rushed. Careful planning can help to avoid problems later including:-

- Problems of enforcing standards.
- Franchisee independence.
- Financial underperformance by the Franchisees.

These problems must be designed out of the Franchise by:-

- Careful selection and training of suitable Franchisees.
- Definition of standards of performance.
- Developing loyalty and team spirit from the outset.

It is to be stressed that this has to be done in the implementation stage. Franchisors who have rushed into recruiting Franchisees have in general had more problems then Franchisors who have taken the time to get the package right and recruit suitable Franchisees. The other major task in the implementation stage is finalising the package of information to be used to recruit Franchisees and the services to be offered. The preparation of these documents and services will involve reviewing the experience of the pilot and revising and refining the concept and these include:-

- The Franchise Contract.
- Operation Manuals and Business Systems.
- Franchise Prospectus and Services.

- *THE FRANCHISE CONTRACT:*

Drawing up a Franchise Contract must be undertaken by legal advisors, preferably with particular experience in the field.

- *OPERATION MANUALS/BUSINESS SYSTEMS MANUALS:*

Operations Manuals and Business Systems for Franchisees are key elements of a business format of Franchise, for if the Manuals and Business Systems are inadequate than the Franchisor will have higher ongoing costs from dealing with Franchisee problems.

- *FRANCHISEE PROSPECTUS:*

The Franchisor should prepare a prospectus which would act as the means of interesting potential Franchisees. It should therefore provide basic information on the costs of establishing the franchised outlet and on it's

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potential performance. These figures should be illustrative of the costs generally to be incurred, and should also be an illustration as to likely revenues, but should not be put forward as a guarantee of potential income. A well produced prospectus is essential as the first stage of developing contact with potential Franchisees.

- *FRANCHISOR SERVICES:*

This would define what the Franchisor will provide for the Franchisees and would normally include back-up

assistance and support. This needs to be carefully prepared as it will form part of the Contract. The pilot should indicate the type and level of services which would be necessary.

THE FRANCHISE LAUNCH:

The Franchise itself requires to be marketed and launched and the capacity to respond to enquiries from potential Franchisees has to be developed. In this regard, once the pilot operation has been established and has been proven, a Franchisor can then seek to make application to the Franchise Association for admission to membership. That in itself will then assist the potential Franchisor in marketing their Franchise.

DEVELOPING A FRANCHISE NETWORK:

Developing the network merely involves recruiting Franchisees and helping them to establish their businesses. For each select Franchisee the Franchisor will:-

- Provide training in the day to day operations of the business, either in a training school or in a company owned outlet.
- Select locations and acquire premises.
- Provide advice on aspects such as shop fitting and interior lay out and design, (where appropriate).
- Assist the Franchisee to open their business, including help with the initial launch plus supervision of a member of the Franchisors staff for the first week or two of the operations.

Different Franchisors undertake these tasks in different ways but the main objective is to recruit Franchisees and help them to get started.

MARKETING A FRANCHISE NETWORK:

The Franchisor also has to market the Franchise. Methods commonly used include:-

- Press advertising, including publications featuring business opportunities.
- Franchise Directories; and
- Franchise Seminars and Exhibitions, such as those organised by the Irish Franchise Association.

The cost will depend on the rate at which the Franchisor is capable of opening outlets and the budget available. As the business develops the Franchisor is likely to become more sophisticated in areas such as Franchisee selection.

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OPERATING A FRANCHISE NETWORK:

The main tasks in operating the network are:-

- Provision of support services to Franchisees.
- Product Development and Market Research.
- Establishing a healthy communication with Franchisees.
- General management and administration.

FRANCHISEE SUPPORT SERVICES:

The provision of continuing support services to Franchisees is one of the distinguishing features of business format Franchising. Support services include:-

- The provision of advice on all aspects of running the business as costs and stock control and local promotion.
- Further training for the Franchisee and/or the Franchisees staff.
- Updating and revision of the manuals.
- Enforcement of standards in all the Franchised outlets.

The Franchisor will also have field staff who will visit Franchisees, their role being to monitor performances, help Franchisees to recognise problems and provide immediate assistance in dealing with problems. There will also be a trouble shooter who will provide a full problem solving service and who may undertake in situ training.

The payment of management services fees is the Franchisor's major source of income and profit. Profits are achieved by maximising the difference between the revenue from fees and the costs of providing the services. The Franchisor must therefore seek to contain demand for services and will do so by:-

- Selecting competent Franchisees who will not be continually calling on the Franchisor for help.
- Providing systems and manuals which will minimise the need for personal visits by Franchisor staff; and
- Selecting locations which would enable the Franchisee to achieve target earnings.

Although the cost of providing continuing services should be contained these services are an essential feature of the business format Franchise and should not be skimped on. The Franchisor must also of course have the capability to provide these services effectively in order to fulfil the terms of the Franchise Contract. For this reason most Franchisors initially develop outlets close to their headquarters or in a concentrated area.

PRODUCT DEVELOPMENT AND MARKET RESEARCH:

These are needed in a Franchise as in any other business and no special explanation should be required of the tasks involved.

COMMUNICATION:

As a Franchise network grows Franchisors establish means of communicating with Franchisees as a way of fostering corporate identity and engendering loyalty to the Franchise network. At the very least Franchisors would have to inform Franchisees about:-

- Developments in products or recruitment.
- Forthcoming promotional campaigns.
- Opportunities for new training.
- Results of Market Research.
- Changes in Government Legislation and/or Regulations.

The nature of the Franchise relationship is such that two-way communication is required and for this Franchisors use:-

- Regular visits to individual Franchisees.
- Newsletters.
- Regional gatherings of Franchisees.
- Seminars for training in specific areas and;
- A National Franchise meeting.

Many Franchisors have encouraged the development and establishment of Franchise Associations which hold regular meetings.

It should be noted that Franchisees also provide valuable feedback on the business itself together with many good ideas for improvements a la Ronald McDonald, which was suggested by a McDonald's Franchisee. In this respect Franchisees participate more fully in the total Franchise operation than paid employees would normally do.

GENERAL MANAGEMENT AND ADMINISTRATION:

In a franchise business, fewer tiers of management are required as day to day decisions are devolved to the franchisees. Therefore a franchise network requires fewer managers and field staff and is accordingly much less expensive to operate.

Business Objectives

Franchising is one possible option for business development and in order to evaluation the suitability of franchising, a set of business objectives should first be set. To use a travel analogy, if a company does not know where it wants to go, it is in no position to decide which is the best route. Therefore the starting point of this exercise is to define where the company wishes to go in terms of:-

- Profit,
- Turnover,
- market share
- diversification,
- cost reduction/rationalization,

Franchising can help companies to achieve all of these objectives, but the real value of franchising is its ability to achieve these objectives within a range of constraints which may be faced by particular companies. The circumstances in which franchising will be successful are examined later. Before proceeding, companies will find the guide more useful if at the outset they review their objectives and examine the reasons for setting any particular objective. Objectives should be qualified in terms of:-

- speed of development,
- geographical areas to be covered,
- how franchising will affect other areas of company activity.

In addition, companies should consider qualitative objectives which may help and set implicitly and have therefore never been scrutinized. These could include:-

Control

Franchising requires a style characterized by leadership, communication and persuasion, and not direct control, and companies have to consider whether the maintenance of strong direct control is an implicit objective.

Participation

A franchisee participates in the franchisor's business to a much higher degree than employees. This can include joint planning and sharing of ideas and information and ongoing development strategy. Companies have to consider whether the maintenance of secrecy and ascension between senior management and others is also an implicit objective.

Ownership

In a franchise, the franchisees own their own businesses, but the franchisor owns the right to the format of that business. Franchising is therefore not a good way to increase the net asset value of the business to be franchised.

Points to Consider

Companies need objectives as the basis for an evaluation of franchising. This will involve companies either reviewing their current objectives and considering the reasons for their existence, or for companies with no, or only ill defined objectives, the starting point should be the setting of objectives.

Franchising requires a radically different management style and companies must consider very carefully whether they can actually adapt to this style.

Franchising can be used to achieve most business objectives but will do in a particular manner. Companies should evaluate franchising in their particular circumstances and consider advantages and disadvantages

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against their objectives. At this stage it maybe helpful to return to the section 2 to reread the attractions and disadvantages of franchising.

The Market

This section deals with the market characteristics, rather than marketing objectives.

In order to succeed as a franchisee, the market for the products or services should possess the following characteristics:-

- profit: the market must allow for adequate profit margins,
- size: the market should be sufficiently large to sustain the planned number of outlets,
- life cycle: the market should not be subject to a short life cycle or continuous changes in tastes,
- protectable: once built up, market share should not be easily eroded by competitors,
- price sensitivity: the market should not be highly price sensitive.

These characteristics are arguably desirable in selling most products or services by whatever method but they are particularly necessary with franchising.

Profit

Low margins for high volume businesses are less satisfactory as franchises because a small squeeze in the margins or an erosion of sales volume by creditor can render the business of both of franchisee and franchisor unprofitable. Franchising is better suited to products or services which can command and sustain high margins, where consumers are willing to pay a premium to enable both franchisor and franchisee to earn an adequate return. Examples include businesses offering:-

- high quality of service and presentation, (health and beauty products for example),
- “instant” services such as printing, picture framing, postal and office services, etc.,
- merchandising with high design content, (knitwear such as Benneton etc).

Size

The size of the market is important in relation to potential sales per outlet. A disbursed market with high sale levels per head of population is more likely to be suitable for a franchise. The larger the population required to sustain an outlet, then the fewer franchises will be established. A product with low projected sale levels can still work as a franchise provided the profit margin is high.

A large growing market is also desirable because it is generally easier to achieve a modest market share. It is also important that the market should acquire customer satisfaction in the delivery of the product or service with, preferably, a local clientele.

Lifecycle

The market for the product or service should be one which is not a fad subject to a short life cycle since such products or services will require major revamp within the period of the franchise contract. This is expensive both for franchisor and franchisees and may give rise to difficulties with franchisee if expensive new investment is required.

Protectable

The market for the product or service has to be protectable to some degree so that other franchisors or independents cannot easily erode market share. One form of protection is of course being first in the field nationwide with an excellent product and some companies have used franchising to achieve this. Other forms of protection include patents, trademarks and secret ingredients, and these are generally considered to afford adequate protection to franchisor and franchisees. However, other distinctive features such as high quality presentation and new technology equipment can be useful in the short term but afford little long term protection.

Price Sensitivity

In order to achieve the necessary price margins it is desirable that the franchise can achieve and sustain premium prices for the goods or services. The market should not be unduly price sensitive and market share should be capable of being influenced by:-

- quality and reliability of service,
- general presentation and style of the business,
- national and local promotion.

Successful franchisors invariably seek to achieve a market edge by developing an attractive presentation of the business to the customer. Franchisees are trained to provide a high quality of service to meet customer satisfaction. On the whole franchises are not suitable for products or services which compete directly on price.

There are of course exceptions to this; one well know franchise was able to undercut others in a price sensitive market by using technologically advanced equipment. The franchisor then retained services of customers by also providing a high a quality service, which enabled margins to be built up over a number of years.

Points to Consider

Any company considering franchising must undertake an assessment of the market to determine whether it can be addressed by franchising. This may require detailed segmentation in the market as franchising maybe the best option for particular market segments, or for particular geographical areas.

The market should have relatively high profit margins, involve customer service at local level, have a long term stable future and the franchise business should be protectable and the product or service should not be price sensitive.

Technical Feasibility

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Franchising must be technically feasible for the business being considered. The following aspects of feasibility are the most important factors to be reviewed:-

- scope for application,
- management,
- product range,
- technology,
- selling the franchise,
- location.

It should be noted that for many businesses franchising will not be feasible without some adaptation to either the planned or existing business format. The purpose of this section is to identify where such adaptation maybe necessary. Where a business is seriously deficient in respect of these factors and cannot be adapted it may not be possible to franchise effectively. However, provided the basic activities are of the right type and can pass the market test experience suggests that adaptation is usually possible.

Scope for Application

If a business cannot be easily replicated it is unlikely to function well as a franchise. To replicate the business it must be possible to reduce the activity of the business to basic elements which can be transferred to each franchisee. Also it must be possible to:-

- devise systems and manual on how to deliver the product or service on operating and managing the business,
- standardized processes and inputs so that there is a high degree of uniformity in different outlets,
- train a wide range of people who may have had little or no experience of the particular activity.

The feasibility of training is the most important as it must be possible to transfer the “know how” required to produce the products and run the business, to the franchisee, who may never have had any previous experience of this particular type of work.

The business must involve a high degree of routine and not be dependent on a particular person’s skills and creativity. This is one reason why fast food outlets can be franchised while gourmet restaurants cannot.

Management

Although in a franchise day to day decision making is devolved to the franchisee the degree of discretion given to franchisees in most franchises is relatively low. In many instances the franchisee is even told the hours when the business is to be open, or when to undertake local promotions. The franchisee therefore will have no strategic decisions to make and only limited technical decisions such as how much stock to order. In cases where considerable discretion has to be devolved to the franchisee, there will be an increased demand for management skills on the part of the franchisee, which may limit the scope for or rate of expansion.

Product Range

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In franchises it takes time to respond to changes in demand as franchisees will not be able to rapidly change their product ranges. With a narrow product range there is the danger the market will disappear or that regional variations in taste will limit the market to those areas where the product has appeal. Where product ranges are too wide there maybe stockholding problems for franchisee who find they cannot sell all items in the range. Franchising is not suitable for markets which require frequent changes in product ranges or whether consumers demand the unique or custom product.

Technology

The technology employed in the franchised outlets must be appropriate for the size of the market which is usually local, the profit potential for the individual outlet, and to the operating capabilities of the franchisees. The technology must be:-

- reliable, so that revenue is not lost because of undue service and repair time,
- simple, so that training is not too costly and that a range of people can be recruited as franchisees,
- subject to only occasional updating, particularly if the equipment is expensive.

If the appropriate technology is very complex or expensive then this will limit the potential of the business as a franchise because the market will perhaps sustain only a very few locations which will generate the necessary profits to fund the required investment.

Selling the Franchise

The franchisor succeeds by selling franchises to the franchisees, therefore the franchisor must understand what potential franchisees look for in a franchise. Generally franchisees are attracted to franchises because:-

- the business itself is appealing
- franchising is seen as a relatively safe route to self employment because of the franchisor's services
- the business offers the prospect of good financial returns

Franchisors must be certain that their franchises are satisfactory in each of these respects.

Business Appeal

Franchisors must find a way to present the work involved in operating the business so that it appears to be interesting and attractive in order not to deter potential franchisees.

Services

Franchisees should scrutinize the ability of the franchisor to deliver a start up and continuing support services particularly training. Companies considering franchising should examine their resources carefully. If resources do not permit good training or the provision of support services, there will probably be problems in both recruiting franchisees and in the performance of individual outlets, which can lead to serious financial problems for the franchisor.

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In retail franchises the selection of premises is such a crucial aspect in determining the level of returns that franchisors should give thorough consideration:-

- identifying the location parameters required in order to maximize sales potentials,
- the costs of such premises and the return from the businesses; and,
- if necessary scaling the business to suit the types of premises generally available in the right locations.

For new or smaller companies, consideration must also be given to the very real possibility of being unable to secure premises in the best locations.

Points to Consider

To work as a franchise a number of technical aspects of the business must be right. Companies with an existing business or new business idea must assess their business against those technical considerations. This should identify where changes are required. In some instances a business maybe incapable of undergoing the necessary adaptations and if that is the case franchising may have to be dropped from the list of options. Most businesses can be adapted however, and once a company begins to look at franchising seriously, expert advice maybe necessary in order to adapt the business to make the most of franchising. The pilot stage which allows the definition of the business format provides the opportunity for testing these adaptations in practice.

Costs and Returns in Franchising

Investment in a Franchise

The ultimate test of whether franchising is appropriate or not is whether it makes commercial sense. The commercial attractiveness of franchising will depend on a great many factors, not least the business itself, the options available for development, the resources available, and the company's own objectives. Therefore each company will have to make its own assessment. Here the main financial parameters are examined beginning with the costs of becoming a franchisor.

Resources Required to Become a Franchisor

Franchisors Initial Costs

The initial costs of becoming a franchisor are defined here as those incurred up to the point where the first franchisee can be recruited. Those initial costs will cover:-

- market review,
- franchising feasibility evaluation,
- concept development,
- pilot operation.
- development of the implementation package,
- establishment of franchisee selection,
- provision for training; and
- franchise launch and marketing.

It is not possible to make a specific estimate of the total costs on become a franchisor, as these will vary considerably depending on the circumstances of each individual company. The key point is that all elements of the process should be costed and in this an allowance should be made for the use of the company's in-house resources as the key cost is the time invested by the company itself. The following points may help in estimating the likely cost.

Market Review

This can be undertaken in-house or by consultants.

Market Feasibility Evaluation

This is designed to indicate whether the basic business concept is suitable for franchising and to identify changes requires in order to make the most of that potential. This would normally be undertaken by a consultant.

Concept Development

If the study indicates that the basic concept has potential as a franchise then the concept has to be refined and developed specifically for franchising!

Developing the concept for franchising can be very straightforward if an existing business fits the criteria for franchising which were the subject of the previous section. However, a favour revision of a business maybe required in order to make it sufficiently simple to be replicable. The concept may also have to be subjected to further detailed market research, or a revising of the whole image of the business, in order to make it attractive to franchisees.

The cost of concept development can be small, or significant, depending on what has to be undertaken. A major input of in-house staff time will certainly be required and there may also be a need for specialist input, particularly in design to include all aspects of corporate identity including:

- logo and trademarks,
- letterheads, stationery and signs,
- display and point of sales material,
- shop fittings and layouts,
- promotional material.

The Pilot Operation

The costs of the pilot operation are the establishment costs and any operating loss in the pilot operation and any costs incurred in redefining the business concept. Total costs can vary enormously depending on:-

- whether business already exists and is being piloted in the franchise format, or whether the pilot is a completely new business,
- the degree of experimentation which the company decides is required or desirable,

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- the actual success or otherwise of the pilot of the business.

For small companies the pilot may be a relatively expensive item, particularly if a significant amount of adaptation and experimentation is required. Small companies may lack in-house skills to establish and operate the pilot and there maybe temptation to commit as few resources as possible to developing the concept. This can lead to flaws in the format which would have been detected had the pilot been undertaken more thoroughly. For the larger company costs can be lower if there are in-house skills to be used, however many larger companies decide to spend larger sums at the pilot stage in order to get the franchise absolutely right. This can include experimenting with or operating more than one pilot and undertaking large scale experimentation.

The pilot stage also involves evaluation of the results, both during the operation of the pilot and a full scale review after say a year. A year is the minimum period which should be allowed for evaluation, and for experimentation and for making any necessary changes. To ensure the pilot stage tests the business format thoroughly it is recommended that two outlets are operated in different markets for at least one year for each outlet. The services of an accountant or a management consultant may also be useful in reviewing the results of the pilot.

Implementation Package

This stage must define the content of the package required before starting to recruit franchisees. Finalising the package involves reviewing the experience of the pilot and revising and refining the concept. There are also specific elements in the package including;-

- the franchise contract,
- operational manuals and business systems,
- prospectus,
- franchising services.

Franchise Contract

Drawing up a franchise contract must be undertaken by a solicitor, with particular expertise and experience in the field.

Operational Manuals and Business Systems

For franchisees these can be produced in-house or by a specialist consultant. If they are inadequate in describing how to operate the business the franchisor will have higher ongoing costs as a result of dealing with franchisee problems and queries.

The Prospectus

This should be an attractive document which stimulates interest among potential franchisees. External assistance will also probably be required in the design and printing and the marketing advice maybe used in preparing a quality document.

Franchisee Services

This denies what the franchisor will provide for the franchisees in start up assistance, ongoing help, and troubleshooting, product development, market research and national promotion. The pilot will indicate franchisee requirements for the services. The franchisor must define these services carefully as they will form part of the contract. The costs of preparing the franchise package will be the franchisor's own time, and any professional input, including that of a solicitor for the contract.

Franchisee Selection Procedure

Experience in franchising shows that the time and money invested in establishing sound franchisee selection procedures is money well spent, because it helps franchisors to avoid later problems with poor quality franchisees. Franchisors may decide to undertake this in-house but serious consideration should be given to taking appropriate professional advice from, say, a recruitment consultant or an industrial psychologist to devise a selection procedure and perhaps aptitude and personal tests or psychometric tests.

Training

The need for training depends on the business itself and on the franchisor's intentions with regards to the rate of recruitment of franchisees. In most retail franchises the franchisor retains one or more outlets in own ownership to use for training among other things. In some businesses only minimal costs are incurred before the first franchisees are ready for training while in other the franchisor may have to establish a training facility and recruit personnel in order to provide the necessary level of training.

Franchise Launch and Marketing

The franchise requires to be marketed and launched, and the capacity to respond to inquiries from potential franchisees has to be developed.

Total Initial Costs

These can vary considerably, depending on four key factors namely:-

- the type of business,
- the degree of adaptation required,
- the availability of in-house skills,
- the company's approach to franchising.

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Where a company has a sound existing business which requires little adaptation to making it into an attractive franchise the costs can be relatively modest. Where significant adaptation is required, or more experimentation is need to get the whole package absolutely right, then costs will be much higher, especially if the franchisor chooses to establish a number of pilot operations. Companies should also remember that time spent by their own staff has, or should have, a value, and in considering the franchise option this should also be costed.

The table on the following page lists the main items for which budget provision should be made and can be used to compile figures.

Points to Consider on Initial Costs

The main point to be made is that on becoming a franchisor it is not something which can be done overnight or on a shoestring budget. Every year a number of new franchisors fail. The main reasons for these include:-

- the franchisor cannot recruit franchisees,
- the business which is franchised is not itself viable,
- the business does not work as a franchise,
- the franchisor cannot provide its services and supplies to the franchisees.

In most instances these difficulties would be avoided if the franchisor committed adequate time and resources to undertaking the appraisal and budgeting procedures suggested in this guide.

Very often when potential franchisors contact me, I refer them to the 40 page guide on “How to Franchise Your Business” and suggest that once they had gone through all the steps mentioned in that, then they should feel free to come back to me. Every often they say that they will back in a few weeks and I indicate that if they are back in 6 months I would be more than pleasantly surprised, and suggest up to a year may be necessary. To properly plan for and implement a franchise development takes considerable time. To implement the pilot stage takes more. Up to two years in total would not be unusual. Intending franchisors should therefore consider whether they have adequate resources to franchise their business properly and this requires a realistic assessment of:-

- the business to be franchised,
- the adaptation required,
- the costs of a proper pilot operation,
- the need for professional input.

By franchising without adequate resources the franchisor not only takes the risks of collapse of his / her own business but also those of his franchisees.

<u>Budget Items</u>

Item	Professional Fees	In-House Fees	Total
Market Review			
Franchise Feasibility			
Concept Development - design			

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Pilot Operation - premises - shop fitting and refurbishment - staff - equipment - stock - other inputs - sales			
Franchise Package - Contract - Manuals and systems - Selection procedure - Training procedure - Franchise launch and marketing			

The Franchisors Operating Costs

Franchise operating costs can be divided into main elements:-

- costs associated with the expansion of the franchise network; and
- operational and administrative costs of the franchisors own business and the provision of support to franchisees.

Expansion Costs

Expansion related costs are incurred when expanding the number of franchised outlets and include:-

- franchise marketing,
- franchisee selection,
- franchisee training,
- location related costs; and
- start up assistance.

Franchisor's Marketing

This can be expensive if the aim is to cover the national territory, to attend exhibitions and seminars, and to sell professionally. A more modest target area and careful use of the media could reduce this considerably, and each company will then have to assess the resources available and determine the appropriate strategy. Marketing costs tend to decline as the franchise becomes better known.

Franchisee Selection

This may become one executive's full time job, depending on the rate of opening which is actually planned. Most franchisors choose to hold one of their interviews at the home of prospective franchisees, because travel expenses can be a major item.

Franchisee Training

The cost of training franchisees depends on the nature of the business and the skills required. In some franchises familiarization training in running a shop is all that is required and this is not expensive. In franchises where a high level of skill is required, then training or retraining maybe more prolonged and a substantial amount of it may have to be off the job. Part of the costs of training maybe recouped if the training is in a company owned outlet.

Location Related Costs

The major element here is the selection of premises. Where quality retail premises are required the franchisor may have to recruit a property manager to find premises and conduct negotiations with landlords. If location is not so important then the franchisee can be delegated to undertake the task, but the franchisor will still have to approve of the location and will normally also carry out the negotiations with the property agent. Staff time and travel expenses will therefore still be involved in assisting franchisees.

The other element on location related costs is advice to the franchisee on layout and refurbishment. The franchisee will normally deal directly with architects and shop fitters.

Start Up Assistance

To assist the new franchisee to get started the franchisor will normally have one or more of his staff helping out in the first few weeks of operation at the franchisee's new outlet. The staff required for this task will of course depend on the rate of opening.

Operational and Administrative Costs

The main elements here are:-

- provision of services to existing franchisees,
- communication with franchisees,
- management of national promotion,
- product development,
- office and other overheads.

All of these elements are difficult to forecast as they depend on the franchisor's development strategy and the product or service being franchised.

Services to Franchisees

The franchisor should provide services of sufficient quality and volume to ensure good performance from the franchisees, without incurring excessive costs from over provision.

The services to be provided are mentioned before and include:-

- advisory and troubleshooter services,
- training,
- advice on local promotion and advertising,
- financial control systems and accounting advice,
- franchisee newsletters and possible formation of franchisee associations; and
- updating and revision of manuals.

These costs are primarily staff time. Field staff are required to provide advisory and enforcement services and troubleshooting can provide in depth problem solving and in some cases retraining. Other important factors include:-

- the type of business,
- the rate of opening of franchised outlets,
- the location of franchised outlets in relation to the franchisor's offices.

Generally costs for services for each franchisee will be high initially, reducing as the franchisee settles into the running of business. With a rapid rate of opening of outlets, the demand of services in total will build up early in the life of the franchisor's operation.

Product Development

This item is highly unpredictable and it will depend on the business itself, changes in technology, the life cycle of the products, and the degree of protection from competitors or changes in market taste.

Office and other Overheads

Successful franchisors range from the very low cost operations using cheap offices and warehousing through to up market operations with very plush offices and images of a successful national business. The level of overheads depends to a degree on decisions by the franchisor about the sorts of premises and operation most appropriate to the franchise. Office overheads do not derive directly in line with the number of units. There are thresholds in the process of expansion which raise overheads in steps. Increases in these costs are typically proportionally then the increase in the number of outlets. Other overheads include the cost of communication with franchisees and management of national promotion. Communication will involve newsletters, seminars and national meetings and the cost of this item rises as the number of the outlets increases. The franchisor will normally manage the national promotional budget, which maybe financed through an advertisement levy on franchisees.

Franchisor Income

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The franchise fee is the first income received from the franchisee, but the ethical franchisor will only earn a very small proportion of total income from this source. The level of franchise fee should be realistic in reflecting the franchise own costs and the value of the licence. In other words it should be intended to cover:-

- the cost of franchise development, (in part),
- the cost of any training provided,
- an element of profit in respect of the grant of the licence.

The franchisor's major source of income on an ongoing basis is the management services fee charged by the franchisor to the franchisee. Where the franchisee is selling products produced or supplied by the franchisor or providing services in accordance with a format specified by the franchisor, then the ongoing payment may take the form of markup on the goods old. Other sources of income are mentioned below. Franchisors will not exploit all of them, and those which are used will usually depend on the franchisors policy and partly on the type of business, but they are included here for completeness.

Income sources can be divided into establishment income and recurring income and the elements in each of these are as follows:-

1. Establish Income
    - initial franchise fee; and
    - startup package.

2. Recurring Income
    - management services fee,
    - profit markups on good sold,
    - advertising levy,
    - markup on rent and/or supplies,
    - percentage of equipment sales and/or leasing.

Later in the life of the franchise there maybe renewal fees as franchisees sign up to new agreements to operate the franchise for a further period. However, generally speaking, no renewal fee is actually charged in practice.

With any franchise it is essential that the franchisee should be aware of the ways in which they franchisor makes his money. This should be fully transparent. Where there are hidden charges or markups then there will undoubtedly be problems later when these come to light.

Franchise Fee

This fee will cover:-

- the licence giving the right to operate the system. The licence itself maybe granted free of charge.
- a share of the franchisor's own startup costs, and
- the cost of recruiting the franchisee.

Startup Package

The franchisee may have purchase items from the franchisor to establish the franchise outlet. A few franchisor charge a handling fee or even make a markup on this, while other pass on items at cost. An alternative is to have the franchisee billed directly by suppliers. Generally franchisors should not exploit their position in this transaction and charging of markup fees is generally discouraged.

Management Services Fees

These are the franchisor's principal source of income and are calculated as a percentage of sales. They should not carry a fixed element. The level of fees are set in accordance with the services provided by the franchisor. The level of fees can be gauged from the franchise survey which is available for download from the Irish Franchise Association website www.irishfranchiseassociation.com.

Management services fees are usually expressed as percentage of the gross turnover of the franchisee (as distinct from being a fixed fee). There are however some "floors" in terms of fees as a minimum monthly fee which would be payable. One issues on an ongoing basis for franchisees is the value for this payment. This is where the franchisor must be seen to be engaging with the franchisor on an ongoing basis.

Markup on Goods

Where the franchisor is selling goods to the franchisee for onward sale by the franchisee, the franchisor will normally charge a markup rather than a management services fee based on gross sales value. Franchisors have a number of opportunities for earning a few extras cents by charging additional markups but this is not generally encouraged. For example franchisors are frequently landlords or have the head lease on franchisee premises and so they can earn a profit on the rent charged to the franchisees, but this is not normally done. Similarly most franchisors supply consumable items, which maybe "tied". A small profit element can be made from this by marking up items. Where such markups are charged franchisee pressure tends to keep this profit down, and it is also an area where the law has changed in favour of franchisees. Now franchisees can not be prohibited from obtain supplies from alternative sources, provided it is of comparable quality.

Equipment

Franchisees normally start their businesses with basic equipment, but as the business develops they frequently invest in equipment with a higher capacity or a wider capability. An example here is the Instant Print Shop which in time requires a much faster photocopy with collating facilities. The franchisor may then earn a profit on the sale of equipment or on commission by arranging leasing for the franchisee.

In large franchises there may also be a national advertising levy, through which franchisees contribute to national promotion. This is normally "ring fenced" and audited as a separate fund to ensure that it is actually spent on advertising and it is not therefore a source of income for the franchisor.

A Hypothetical Financial Case Study

The financial case study hypothetically presented in the tables which are going to follow is a highly simplified one covering a franchise operation from the pilot through to the end of the first 5 years of opening franchises. The costs are purely indicative and they should not be used as guide to the actual costs of becoming a franchisor. The figures are simply figures which have been taken for the purpose of illustrating how the financial matrix might work. The case study could be made more sophisticated by dividing each unit into quarters and incorporating assumptions about when fees are received and when franchisor expenditure incurred. A complete financial model could also incorporate liability for tax. The model as presented here is therefore an end year cash flow model and as such does not take account of changes in the cash positions throughout the year.

It is assumed that the company is a medium sized one which decided to franchise an existing business which has developed slowly in its local area. Only three outlets have been opened and while fairly successful the existing business had a somewhat old fashioned and down market image.

The company's objective is to secure more rapid development of the business without injecting a large amount of capital. The company also did not wish to become too closely involved in managing a chain of outlets.

It is assumed that the cost of becoming a franchisor, based on figures inputted is just short of €200,000. Depending on the degree of sophistication involved in the preparation of the business, this could be higher or lesser.

It is assumed the company was able to draw on in-house skills in most area but had to use professional help:-

- market review,
- survey of customer attitudes to their existing business,
- a franchise feasibility study by a specialist consultant,
- design, for the interior of the shop and for logos, signs, etc,
- the franchise contract,
- the preparation of manuals and systems,
- assistance with establishing a selection procedure; and
- marketing the franchise and preparing the franchisee response pack.

The costs of becoming a franchisor, as presented in the table below, includes the total cost of the pilot operation, less the sales made through the pilot shops. It is assumed the pilot actually cost an additional €70,000 to establish by refurbishing the existing shop and purchasing new equipment. It is assumed the pilot achieved an additional €30,000 in sales so that the extra cost to the company on the pilot was €40,000. It is assumed the company then launched its franchise and was able to achieve a higher rate of opening with five in its first year, ten in the second and fifteen per year until year five by which time it had sixty franchised units and the company owned one. It is assumed by year five the need for franchising marketing had declined as the projected number of new opening in subsequent years was low. However, in year five, a major effort, it is assumed is going to be made to develop the product and this it is assumed will raise the overhead costs substantially.

The Results

It is assumed the overall company results will be as illustrated in the second table. The accumulative profit performance is highly typical of a franchise, with larger planned costs and first year losses being gradually reversed as the number of outlets builds up and the franchisees begin to increase their sales. Year two is the peak year for the accumulative loss and a positive profit position is not achieved until year four. The return of capital is high and alternative measures can be used by using the ratio gross profit total financial exposure in the year 5 ratio is 227%.

Points to consider

The case study here is realistic in one sense in the context of the type of company described here. Other companies would have different figures, but the main features of franchisors overall financial performance do not vary greatly in that:-

- there is a large upfront element of investment,
- on an accumulative basis, a positive position is not achieved until around three to five years of trading activity; and
- the return on capital is high in a successful franchise.

Companies considering franchising because of a shortage of capital must therefore consider the following points carefully, comparing their position with that of the illustrative example in the case study:-

- are there potential reasons why the cost of becoming a franchisor can be reduced significantly, without cutting corners, or would the costs be higher?
- can the rate of opening of franchised outlets be raised significantly?
- will acquisition of properties and recruitment of franchisees be sufficiently rapid to enable a high rate to be achieved? If there is a higher expansion rate this will obviously increase the franchisor's income and expenditure in the financial model.
- will the franchise sales will higher or lower particularly in the first year or two?

Companies are urged to be realistic about their own capability in establishing a franchise network, for only in exceptional cases will a company be able to achieve a higher positive profit position or significantly reduce their financial exposure.

The examples given are purely illustrative to illustrate a methodology or approach. Professional help should be enlisted in preparing a financial spreadsheet.

Financial Case Study

Item	Professional Fees & Other Payments	In-house Staff	Total
Market review	€2,000.00	€2,000.00	€4,000.00
Franchise feasibility	€6,000.00	€2,000.00	€8,000.00
Concept development	€0.00	€4,000.00	€4,000.00
Design	€10,000.00	€2,000.00	€12,000.00
Pilot operation			
- premises	€50,000.00	€0.00	€50,000.00
- shop fitting & refurbishment	€40,000.00	€0.00	€40,000.00
- staff	€50,000.00	€20,000.00	€75,000.00
- equipment	€20,000.00	€0.00	€20,000.00
- stock	€10,000.00	€0.00	€10,000.00
- other Inputs	€20,000.00	€0.00	€20,000.00

- sales	€100,000.00	€0.00	€100,000.00
- evaluation & experimentation	€0.00	€6,000.00	€6,000.00
Franchise Package			
- contract	€4,000.00	€0.00	€4,000.00
- consultants fees	€4,000.00	€0.00	€4,000.00
- manuals & systems	€12,000.00	€0.00	€16,000.00
- selection procedure	€2,000.00	€2,000.00	€4,000.00
- training procedure	€0.00	€2,000.00	€2,000.00
- franchise launch & marketing	€20,000.00	€2,000.00	€22,000.00
Totals	**€150,000.00**	**€46,000.00**	**€196,000.00**

Five Year Result

	Year					
	0	1	2	3	4	5
Opening						
Pilot	1	0	0	0	0	0
Franchised	1	5	10	15	15	15
Total Opened	**1**	**6**	**16**	**31**	**46**	**61**
Income						
Company owned outlet (net)	€0.00	€0.00	€20,000.00	€24,000.00	€24,000.00	€24,000.00
Franchise fees	€0.00	€50,000.00	€100,000.00	€150,000.00	€150,000.00	€150,000.00
Management services fees	€0.00	€20,000.00	€80,000.00	€190,000.00	€340,000.00	€510,000.00
Supplies to franchisees (net)	€0.00	€4,000.00	€16,000.00	€38,000.00	€68,000.00	€102,000.00
Totals	**€0.00**	**€74,000.00**	**€216,000.00**	**€402,000,00**	**€582,000.00**	**€786,000.00**
Expenditure						
Startup costs	€196,000.00	€0.00	€0.00	€0.00	€0.00	€0.00
Franchise marketing	€0.00	€50,000.00	€75,000.00	€50,000.00	€40,000.00	€20,000.00
Franchisee Selection	€0.00	€40,000.00	€40,000.00	€40,000.00	€40,000.00	€40,000.00
Location Selection	€0.00	€20,000.00	€40,000.00	€40,000.00	€40,000.00	€40,000.00
Franchisee Services	€0.00	€20,000.00	€60,000.00	€90,000.00	€90,000.00	€80,000.00
Overheads	€0.00	€50,000.00	€50,000.00	€70,000.00	€70,000.00	€100,000.00
Totals	**€196,000.00**	**€180,000.00**	**€260,000.00**	**€270,000.00**	**€280,000.00**	**€280,000.00**
Profit (loss) for year	(€196,000.00)	(€106,000.00)	(€44,000.00)	€112,000.00	€302,000.00	€470,000.00
Cumulative profit (loss)	(€196,000.00)	(€302,000.00)	(€346,000.00)	(€234,000.00)	€68,000.00	€574,000.00

Assumptions of the Model are:

- Franchisee turnover profile
  Year 1 of operation €80,000.00
  Year 2 €160,000.00
  Year 3 €200,000.00
  Year 4 €240,000.00
- Management Services Fee is 5% of turnover
- Profit on franchise package is €84,000.00
- Supplies to franchisees produce a net profit of 1% on franchisee turnover
- The advertising levy is totally spent in each year.

A Summary of Points to Consider when Considering Franchising

This guide will have taken you through an assessment process, beginning with your objectives and ending with the resources and returns of franchising. Hopefully, you should now be better informed in relation to whether or not it is worthwhile to consider committing resources to looking and franchising your business.

Franchising is likely to be only one option for the development of your business and you should submit all of your options to the same scrutiny in reaching a decision on whether it is worth pursuing the franchise option further. To help, this summary presents the points you should consider and decide on your next steps in franchising.

Business Objectives

You must be as clear as possible about your business objectives and why you would want to expand your business through franchising. Franchising is a means of expanding a business, but it not the only method. Are you certain you know why your business is seeking to expand? Simply wanting to franchise your business is not a sound approach to business planning, and you should defer a decision on franchising until you have a clearer idea of your company's overall development strategy.

For the larger company objectives which can be achieved by using franchising include:-

- improving management efficiency in existing outlets,
- developing a new business concept,
- expanding sales through dedicated outlets,

For a smaller company franchising can overcome a capital constraint on expansion, but you must also ensure that adequate resources exist to cover the cost of establishing the franchise and the financial exposure of the first few years of operation.

If your company is seeking rapid expansion then you should take a realistic view of what will be possible by franchising, as you may require 6 months to a year of planning plus at least one year to pilot the franchise before being in a position to offer any credible franchise package to franchisees, and then start recruiting franchisees.

Management

Managing a franchised chain involves a totally different management style and not every company's senior executive or principal can adapt. You will have a very difficult time if you franchise and try to treat franchisees like your own staff. You must look at how decisions are made in your business now, and whether there is a participation or autocratic style of management. How good are you and your staff at listening to others and how receptive are you to other peoples suggestions and ideas? Do you get the best out of your staff? If not, will you be able to lead and inspire your franchisees.

For the larger company with traditional management structures and attributes, franchising can be something of a shock to the system and you have to be certain that everybody at board level is behind the changes that

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franchising will require. It is no use playing at franchising as this would be irresponsible behaviour towards franchisees. As the change in management style can be a major obstacle there has to be a commitment to seeing the changes through, otherwise there will be a potentially costly programme of buying out the franchisees in 3 to 4 years time.

Suitability

It is essential that your existing or your intended business can be franchised or can be adapted to be franchisable. You should look at the sections on the market and technical feasibility and mentally score your own business. In particular it is:-

- sufficiently profitable,
- in a long term market,
- protectable and distinctive,
- replicable.

Do you know what the success parameters of your business are? If not how do you know what is a good location or what potential there is for sales. If it is a new business format can you be sure that the business will be attractive to franchisees in general and specifically in the locations you will be offering franchisees. Whether your business is large or small, you should devote adequate time and resources to undertake a detailed appraisal of the suitability of your business for franchising.

Resources

Franchising requires a significant upfront resource committment, plus substantial working capital until the franchisees are established and you start earning fees. You must look at the cost of franchising, especially if your business needs to be adapted. Do this realistically, costing your own time and the use of your own staff as well as any outside expertise. You must also make some realistic cash flow and profit projections, and establish the circumstances in which you can and cannot afford to franchise. If you find you need a high rate of franchise opening do you have the staff and expertise to find locations, recruit franchisees and help them get started? Are you being realistic about what you can achieve?

Franchisee Selection

For large companies resources are likely to adequate to establish franchisee selection procedures and to bear the costs of the lead time involved in finding suitable franchisees. For smaller companies the temptation is to cut corners by not placing sufficient importance on the selection of franchisees. Experience has shown that this almost invariably causes problems later on. A small company considering franchising must look at whether its resources are adequate to undertake franchisee selection in a thorough and competent manner.

External Advice

Where you company is large or small you will also need external help from a solicitor and an accountant plus possibly specialist advice regarding a franchise feasibility study, market research and the preparation of manuals. Again are you realistic about what advice you need and what you could do for yourself?

Commitment

Franchising involves a long term business relationship, as you need commitment to the system and to your franchisees. You should be realistic about this, because while real returns can be made in the long run you will have a tough time for two or three years before you turn the corner. This may seem fairly formidable but, unfortunately, a small number of franchisors go out of business every year. Some do so before they have even sold a franchise because of the adverse cash flow. But in these cases no one else goes down with them. Others go out of business in the difficult first two years and sometimes the franchisees go down too. Becoming a franchisor means taking responsibility for your franchisees so it is not something to be taken lightly.

Next Steps

By using this guide you should be able to make an initial assessment of whether or not Business Format Franchising represents a possible option for the development of your business. If franchising appears attractive, then the next step is to undertake some more detailed investigation. You should not attempt to do this entirely using your own in-house staff resources, particular if you have little or no experience of franchising. You will also benefit from a objective outside view on your plans. If you do decide to proceed, your next steps should be:-

- further reading on franchising,
- defining a work programme and a budget for a more detailed investigation of the franchising option,
- contact with the Irish Franchise Association who can supply further information and refer you to consultants and solicitors,
- contact with your bank.

You may also wish to discuss the franchising option with Enterprise Ireland, who maybe in a position to assist with grant aid. Taking a systematic and professional approach to franchising your business will avoid many of the traps that others have fallen into. It is important that an ethical approach be taken to franchising. Unfortunately, franchising can be used as a get rich quick scheme by some, and this will only harm everyone particularly of course any franchisees who are defrauded by an unethical franchisor, but also ethical franchisors who are trying to expand and recruit franchisees. It is for this reason that franchisors are expected to sign up to the Irish Franchise Association Code of Ethics.

It is fairly easy to become a franchisor, of sorts, in Ireland. No licence is required and there is no legislation comparable to that of the USA which requires full disclosure of information on the franchisors business, and the people who are offered a franchise. In Ireland, franchisees are treated as businesspeople, or should be fully capable of assessing the business risks. Indeed any well drawn agreement drafted by a competent solicitor will include provisions providing that the franchisee is deemed to have made an independent assessment and judgment in relation to the business risk involved in the venture, and is deemed, (whether they have or have not), to have taken legal and professional advice in relation to the agreement. In many cases it maybe that the franchisee has not taken professional advice and/or is not capable of assessing business risks, even if the information needed for someone to assess those risks is made available. It is therefore perfectly possible for someone to set up a fraudulent scheme or to franchise so incompetently that there is in fact no hope of success. The only limitations, apart from the law generally and out and out fraud are:-

- franchisee awareness of the risks on how to spot a poor franchise,
- the attitudes, awareness and competent of the lending institutions,
- the franchisor's own business ethics.

The Irish Franchise Association seeks to promote an understanding of Business Format Franchising and the ethical standards which should be observed, and this will help franchisees to evaluate franchises.

Similarly the lending institutions all have sophisticated business development units who are in a position to assess business opportunities and franchise systems in particular.

The Irish Franchise Association is anxious for Irish companies to realise the opportunities for franchising but this encouragement is restricted to the promotion of ethical and competent franchising.

Essential Consideration

In order to franchise ethically there are four essential considerations:-

- commitment,
- business base,
- returns,
- resources.

Committment

A franchisor in offering a franchise invites people to invest what maybe a high proportion of their lifetime assets in a business which the franchisor has devised. Accordingly, there is a heavy responsibility on the franchisor to franchise ethically. It is also in the franchisors own interest, because the real benefits of becoming a franchisor accrue in the medium to the long term. If the franchisor attempts to charge too much for the franchise fee, or cut corners in preparing the franchise package, more maybe earned initially and costs reduced, but, by doing this the likelihood of franchisee failure is increased. Franchisee failure not only deprives the franchisor of fees in the longer term, but also makes it more difficult to recruit further franchisees. A successful franchise involves a commitment by the franchisor:-

- to invest the necessary recourses in order to franchise competently from the outset,
- to a long term relationship with the franchisees.

Business Base

This must be proved by having operated for at least a year on a pilot operation and preferably in more than one location.

Returns

The major source of income should be the management services fee, which are a longer term source of income. The franchise fees which represent an upfront payment, should not be used as a gross source of profit.

Where a franchisor earns large sums for franchise fees, there is much less of an incentive to supplying the services to help the franchisees to carry on their businesses.

Resources

Sufficient resources are required in order to test and implement the business format and to finance the initial loss making period. Franchising will prove successful where both the franchisor and the franchisees are committed to and have an incentive to continue in a long term business relation. This requires time and money and so franchising must not be seen as a way of making money quickly.

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Bill Holohan & Associates
--------------Solicitors-------------

Profile of Bill Holohan

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The Principal of the firm is Bill Holohan, B.C.L., LL.B., F.C.I.L.S., F.C.I.Arb. He is a Solicitor, a Notary Public, an Arbitrator, a Trade Mark Agent / Community Trade Mark Practitioner and is a Commissioner for Oaths. He is one of the few Irish Solicitors who has appeared, (without barristers), in the High Court and in the Supreme Court when arguing cases on behalf of clients. He has been described by the Sunday Business Post, (the leading weekly business newspaper in Ireland), as a "groundbreaker" and as "innovative".

In 1995, the Sunday Business Post featured him as one of the top 40 entrepreneurs / senior managers in the country, then under 40 years of age. In 1986 he was appointed by the President of the High Court as a Commissioner for Oaths, In April 2000, he made legal history when he was appointed as a Notary Public for the Cities and Counties of both Dublin and Cork. Traditionally, a Notary Public was appointed for one area only and Bill Holohan is the first person to be appointed for both Dublin and Cork. The Chief Justice, Mr. Justice Ronan Keane, in appointing Mr. Holohan described him as "pre-eminently qualified".

In 2000 he was also requested by the International Arbitration forum to become the first Irish solicitor on their International Arbitration Forum Panel of Arbitrators.

In January 2003 he was named as the Cork Business News Magazine Business Person of the Month.

In 2003 he was also appointed to the Mediator and Adjudicator Panels of the Private Residential Tenancies Board.

In 2004 he was featured by Vodafone as one of the voices and faces of SME's in Ireland.

Mr. Holohan is the co-author of a number of books on Bankruptcy, Leasing, Civil Procedures and the Rescue of Companies. He is also the Honorary Legal Advisor to the Irish Franchise Association, a member of the Executive Committee of the Irish Maritime Law Association since 1985, having acted as Honorary Secretary to that Association for a number of years, and is a Consultant to the Law School of the Law Society of Ireland.

In his private capacity, he has been involved in youth work in Ireland for a number of years having served six years as National Secretary of Scouting Ireland C.S.I., two years as Chairman of the Federation of Irish Scout Associations, six years as the Chairman of the Northern Ireland Scout Foundation, and also was a National Youth Council of Ireland Representative on a Department of Enterprise Trade and Employment Committee reviewing Youth Employment Legislation. As a result he has considerable knowledge and insight into the workings of Government Agencies.

Mr. Holohan's business knowledge is not confined solely to an advisory role. In addition to acting as solicitor

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