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SOME PLAIN TALK ABOUT FRANCHISING

SYNOPSIS — Franchising is both more and less than its mythology would have us believe. This article illuminates some of the dominant fallacies as well as some of the untapped possibilities of franchising as a business method. It is a "must read" for anybody exploring the idea of getting into franchising, either as a startup wanting to be the next McDonald's or as a major corporation seeking to rejuvenate distribution channels while cutting costs. From *Issues in Franchising*, No. 21. *By E. Todd Ellison & Jean-Louis Janssen.*

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SOME PLAIN TALK ABOUT FRANCHISING

by E. Todd Ellison and Jean-Louis Janssen

The field of franchising is blessed with an abundance of myths. These range from the notion that franchising is a "get rich quick" scheme to the idea that franchising is only for "mom and pop" retail businesses. Or the myth that if your company is loaded with cash, franchising isn't the expansion strategy for you. Because we hear these myths all the time, we thought it was time to revisit some of the core ideas behind franchising and set the record straight on at least a few of the most pervasive myths.

This article focuses on franchising mainly from a corporate perspective, but with one exception. We close with a somewhat different slant on the famous question: "Should I franchise my business?"

Part 1
Franchising, Then and Now

First, What Is Franchising?

Yellow Cabs have a franchise. The Chicago Bulls are a basketball franchise. McDonald's is a famous fast food franchise company. These are a few examples of the word "franchise" in popular usage. Underlying all these usages is the concept of a "right" or "privilege" which is granted by some party to some other party. Centuries ago, European royalty did the granting, usually of a right to operate a monopoly of one sort of another. In the mid-nineteenth century, Isaac Singer and Cyrus McCormick began applying the concept to business, granting rights to third parties in an effort to sell their products, sewing machines and harvesting machines respectively, in places distant from their factories.

In business today, perhaps the most useful definition of the word is this: a formal arrangement through which one party sells the products of another (or uses another's business system — see below), usually on an exclusive or semi-exclusive basis. This definition is broad enough to encompass all forms of what we commonly call "franchising" as well as other third party distribution methods, including licensing and distributorships.

Second, Who Are the Franchisors? (Or Franchisers?)

Today, when we talk about franchising as a business method, McDonald's is usually what first comes to mind. Why is this? Why not Coca Cola, an equally famous franchisor? Or Ford Motor Company, another well known franchising pioneer? Or Texaco, yet another well known franchising pioneer? All these companies are franchisors in one form or another.

What has become synonymous with the business of franchising today is a relatively recent variation, the business format franchise (BFF), where the product that is franchised is a business system, as opposed to a product or product line — branded motor fuel, a proprietary soft drink formula or a brand of automobile. A BFF is the right to use somebody's "knowledge of how to make money" as the Wall Street Journal put it in an article about Holiday Inn founder Kemmons Wilson. Business format franchises have become ubiquitous, dotting the retail landscape in increasing density. Virtually inescapable today, this business innovation has been a remarkable success story.

The phenomenal success of the BFF, however, tends to mask the fact that it is just one of a number of different franchise techniques that can be used to accomplish this key objective: granting other businesspeople the right to sell your branded products, so you don't have to be everywhere your customers are. This fundamental objective is at the core of virtually all franchising and related third-party distribution methods.

What Good Is Franchising, Anyway? What Are the Payoffs?

Why get other companies to sell your products? The answers typically have to do with money, market penetration and branding.

For certain kinds of products, having third parties take on various distribution and marketing tasks is a very effective way of expanding market coverage of branded products at minimum cost. It is no coincidence that franchising's first wave — product/tradename franchising — occurred at the time when branded products were coming into vogue during the early decades of this century. Improvements in transportation and communications made it possible to cost-effectively stimulate broad demand for branded products for the first time in history. Branding in, undifferentiated commodity products out. Franchisors of this era discovered that franchising could solve knotty distribution problems with someone else's capital while simultaneously expanding the reach and value of their brands.

True to form, the rationale for franchising's second wave — business format franchising — is identical to the rationale underlying earlier first wave franchisors like auto manufacturers, oil companies and bottlers: growing a brand with someone else's capital and elbow grease. The core structural difference between the first and second waves was that what was franchised was a business system.

The Third Wave: Expanding Franchising's Potential

As business challenges are evolving, so are franchising techniques evolving to provide solutions. Particularly interesting are the permutations and combinations of established and innovative franchising techniques. Here, at the verge of a new millennium, third wave franchising strategies can offer solutions to some very real business challenges. Here are some of the benefits:

- Strategic alliances based on franchising principles can cut costs while generating new sources of revenues.
- Franchising techniques can provide superior ways of managing resources and managing motivation.
- Franchising techniques can provide increased control over distribution and marketing without the obligations of ownership.

Having identified a few areas of

opportunity, let's consider them in a little more detail.

Strategic Alliances to Cut Costs While Adding Revenues

By restructuring an existing distribution channel using franchising principles, it may be possible to eliminate or reallocate entire layers of management while adding new sources of distribution sector revenue: fee income, via franchise fees and royalty fees.

There is also a quality of income factor to be considered; royalty income is typically based on gross sales — money off the top. The net income side of the equation often the most elusive to achieve in distribution and marketing — is the responsibility of the distribution partner (the franchisee) who, as a specialist, is typically better suited to squeezing profits from his efforts.

Superior Management of Resources and Motivation

Doing more with less — increasing productivity — is one of the pervasive themes of the current decade for established companies. Yet successive waves of layoffs have left little "fat" and "deadwood" available for trimming, and real cost-cutting via productivity increases has been elusive in many industries. Under pressure from analysts and shareholders, some public companies are now cutting muscle and bone with the hope that the effects won't show up until it's someone else's watch. Advanced third wave franchising techniques offer ways of cutting costs by transferring major chunks of business activity to an entrepreneurial alliance partner with a more favorable cost structure.

Properly structured, such distribution and marketing alliances improve the motivation equation as well, often leading to increases in sales and profits over the same function under corporate ownership. Further, for companies who make their livings by distributing things created by others, customers and marketing are at the top of their value chain. In most large companies which are product producers, distribution tends to be toward the bottom of the value chain.

Smaller, younger companies also typically have more latitude for motivational management than larger companies whose legacies of costly, company-wide "benefit programs" are often of questionable value as motivators of employee performance. In addition, smaller, younger companies are usually better at responding to changing local conditions, and thus tend to perform better at the retail level than large corporations.

Control Without the Burden of Ownership

One of franchising's strengths has been mastering the fine art of control in a contractual — as opposed to an employment— business relationship. While the control issue is sometimes raised as potentially problematic by large corporations with vertical traditions, the issue is, for the most part, illusory.

In the first place, large companies have far less real control over employees today than they have had in the past, but rarely find it convenient to acknowledge this reality. In the second place, contractual control systems — contracts and agreements — focus on economic performance, as opposed to behavior. Thus, they are often better suited to achieving the outcomes that matter most. Further, franchise companies have evolved ways of managing important intangibles like "quality" and "brand" through contractual relationships, often with more success than through the more traditional in-house processes.

Part 2 Revisiting Some Popular Myths

MYTH 1 – Franchising is Only for Cookie-Cutter Businesses

What is usually meant by a "cookie-cutter" businesses is one with a highly standardized business system and also a standardized visual presentation. Are

both of these required for success in franchising today? Let's look at the issue from both system and appearance perspectives.

This appearance factor is arguably most responsible for creating the cookie-cutter myth. Conjure up images of some popular 1960s-era restaurant chains and you'll get the picture: McDonald's with their soaring golden arches and highly standardized building designs; Der Wienerschnitzel with its signature A-frame structure, Pizza Hut with its characteristic roof line resembling a four-sided witch's hat, IHOP with its blue roofs. Today, however, new stores in these chains sport a wide variety of different appearances and hardly qualify as cookie-cutter designs. Yes, they still have certain consistent thematic or stylistic threads, but the whole box no longer looks cloned; even franchises that helped create the cookie-cutter myth no longer look like stamped identical parts. Franchisors have discovered that rigidly standardized appearance is no longer either practical or particularly desirable in this age of diversity and market saturation.

The fact is that even in the 1960s and 1970s, many — if not most — franchise companies did not require rigidly standardized facilities. Nor did they need them to become successful in their fields. How many franchised haircutting parlors or real estate offices were cookie-cutter designs? Hopefully, we can lay the appearance side of the cookie-cutter myth to rest. Consistent brand representation? Yes. Consistent color schemes? Maybe. Cloned box? No.

The waning of this myth opens the franchise door to many companies who have a marketable brand and business system but whose products/services don't fit in the old cookie-cutter appearance myth. One of the biggest growth segments in franchising today, for example, is in business-to-business: security, business brokerages, mortgage brokerages, facility maintenance, temporary employment agencies and outplacement services are a few examples. Not exactly cookie-cutter type businesses.

The system side of the cookie-cutter myth — requiring all franchise units to operate in a standardized manner — is a more complex issue. In business format franchising, standardization has long been the pathway to delivering consistent, predictable quality to customers. Standardization worked. It was so successful, in fact, that for a number of years it became increasingly rigidified: no deviations allowed.

Standardization has a dark side, though. In today's fast-changing, highly competitive, de-massified marketplace, slavish devotion to a "by the rulebook" doctrine tends to stifle innovation and slows responsiveness to changing consumer and competitive patterns.

Some daring franchisors, such as the young Great Harvest bakery chain, are discovering that sys-

A Brief Aside on Innovation in Franchising

Franchisee innovation represents an abundant source of opportunities even for existing franchisors, assuming they have the organizational will and savvy to alter historic patterns of top-down, dictatorial management.

In any case, it is difficult — and counterproductive, these days — to maintain the fiction of franchisor omniscience, particularly when the plain fact is that most product and service innovations are developed by franchisees, not franchisors. This should not be surprising: it has been well documented that small firms (like franchisees) innovate at double the rate of larger firms (like franchisors). Nor is this a slam against franchisors: it's the franchisees, after all, who are on the front lines with their own investments at stake and often very little financial cushion to fall back on. Necessity is the mother of innovation.

The upshot of this digression is that innovation is an essential — not optional — component of successful businesses in today's world. And tomorrow's. Entrepreneurs and established companies contemplating entering franchising today should give careful consideration to the way they structure and manage the franchise relationship: the goal should be to encourage and support continued improvement and innovation while retaining enough consistency to build a unique and potent brand. Not easy, but well worth the effort.

tem performance can be increased by actually throwing away the rulebook and encouraging change and innovation by franchisees. "Radical" adventures like this are responses to changing market conditions and new communications technologies that place a premium on responsiveness and adaptability. And why not? The bottom line, after all, is the bottom line: enhancing it for franchisees enhances it for the company as well. With today's more knowledgeable and demanding customers, strict adherence to the franchisor's rulebook is not the only path to a successful franchise business.

MYTH 2 — Franchising is Only for Mom-and-Pop Retail Businesses

Maybe this myth is a corollary of the cookie-cutter myth, the presumption that since most cookie-cutter businesses feature modest-sized retail outlets, franchising must just be for companies with a similar retail presence. Not so. There are plenty of examples of wholesale and business-to-business franchise enterprises, and many other examples of large corporations whose portfolios include franchised businesses.

On the size end of this myth, the hospitality industry includes an abundance of franchised brands. All require multi-million dollar investments, with some reaching into the tens of millions per unit. Not exactly "mom and pop" retail businesses. Many of the franchisors of these chains are Fortune 500 companies, as are some of their franchisees. And large corporations are in many other segments of franchising as well, including car rentals and leasing, gasoline and convenience retailing, real estate brokerages, food service and more.

MYTH 3 — We Have the Money to Build Corporate Stores, So Franchising Isn't for Us

The argument goes something like this: if raising the capital to build stores (or stations, or centers or hotels or whatever you call your retail outlets) is no problem and if you make more profit off company-owned facilities, why franchise? After all, in classic franchising settings revenues from franchised operations are limited to an up-front fee and an X percent royalty on gross sales. True. For some companies in some economic climates, franchising may be less appealing than company-financed expansion. In less expansive capital climates than the current long-running bull market though, franchising can become a virtual necessity if growth is to be achieved. And even when capital is flowing freely, there are many situations where franchising still makes good business sense. Here's one example.

In a highly competitive marketplace where rapid market penetration is important, franchising will allow you to open more units faster than a straight corporate effort.

In secondary geographic markets, where corporate infrastructure would be stretched too thin or which would be too costly to enter, franchising is often a good bet, particularly using an area development approach. Secondary markets are often places where innovative forms of franchising — such as co-franchising with established distribution companies — can be implemented.

MYTH 4 — Franchising Is a Paperwork Jungle: Why Bother Complying with All Those Regulations?

Big, big myth. We heard this myth recently from a Fortune 500 company that was reluctant to "franchise" and, instead, had created a 400-page licensing agreement that brought in no revenues from licensees. Go figure.

Here is the reality. In the first place, regulatory compliance in franchising is hardly rocket science. Most franchise regulation has centered around providing adequate informational disclosure to prospective franchisees. Only questionable companies have anything to fear from full disclosure under franchise regulations. Preparation of disclosure documents is very little different than the preparation of a

"red herring" for the purposes of raising investment capital. For public companies, preparation of disclosure documents is a gnat on an elephant's hide compared to the ritual of the corporate annual report to the SEC. And existing regulations require very little in the way of ongoing reporting. Nor is registering to sell franchises in the states that require it a challenging or costly process.

The other "paperwork jungle" issue we hear raised pertains to franchise agreements. Another vapor issue. Franchise agreements are no more onerous to craft than any other kind of business contract. And once created, they can usually be cloned verbatim for years. Cost-wise, except for very small, very undercapitalized businesses, this aspect of starting up a franchise program is a non-issue.

The real truth is that franchise agreements should properly be viewed as an important business asset. Not only do they provide the franchisor with the means of controlling the relationship, the common sense compliance systems that go along with a well-designed franchise program provide an excellent means of tracking performance, providing early warning of problems with individual franchisees and detecting important systemwide development and performance patterns. And it's all there in black and white.

Part 3
The Universal Question: Should I Franchise?

The short answer is "no." What, you're shocked? The fact is that most people with small retail businesses — or business concepts — should not franchise their businesses, for any number of reasons, these included:

- ***It's a me-too, imitative business.*** There's always room for a No. 1, a No. 2 and a No. 3. But a number 748? Even legendary local businesses often flunk as franchise concepts.
- ***It's a fad business.*** Here today, gone tomorrow. You won't want the lawsuits.
- ***Bad timing.*** The market isn't quite there yet, or it came and went already.
- ***You don't have enough money.*** Setting up to be a successful franchisor takes money and time; more money and time than most consultants will tell you. Often far more. And starting to sell franchises when you're not ready to support them (see the "Franchisees as Capital" myth below) is a business nightmare waiting to happen. You might have gotten away with it twenty years ago, but today's franchise buyers are a pretty savvy bunch and they have a lot of business opportunities to choose from.
- ***Your personality or corporate culture is not suited for franchising.*** Not every entrepreneur is, and not every corporate culture is. Some people just don't have the patience and support mentality that being a franchisor demands. Nor are some corporate cultures able to adjust to the realities of managing a franchise business. Being a franchisor is a much different proposition from being an anything-goes, shoot-from-the-hip entrepreneur. Some individuals and companies can learn and adapt, some can't. Or won't.

The "Franchisees as Capital" Myth

One last myth, and another wrong reason for wanting to franchise. This one illustrates the dangers of too much arithmetic and too little common sense. Calculating the value of, say, one hundred franchise fees — the up-front fees that new franchisees typically pay to a franchisor — can lead the uninitiated (and perilously overoptimistic) to believe that franchisees themselves are a source of capital for launching a business.

Let's see: 100 franchisees times a $25,000 franchisee fee is $2.5 million. Or $1.25 million for selling a measly 50 franchises. Nice chunk of development capital for a young or startup business? Or a quick way to dig oneself a very deep, very dangerous hole? The latter, of course. We're reminded of the old adage that getting a return on an invest-

ment (unfortunately) requires making the investment first.

In this case, the investments required first are the systems and support machinery that will allow franchisees to be successful. Selling franchises before these mechanisms are in place is a virtual guarantee of unsuccessful franchisees. For young franchise systems trying to build a name in the business opportunity marketplace, unsuccessful franchisees start a negative feedback loop that can stop a franchise program in its tracks, leading to lawsuits and ultimately business failure. A variation of the famous Orson Welles wine commercial comes to mind: We will sell no franchise before its time.

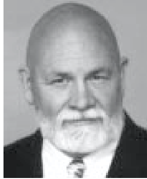
Is Franchising Really That Bad?

Not at all. But sadly, there are a lot more reasons for not franchising a business than there are reasons to go ahead with franchising. Franchising is not for everybody. Every year, people try it who shouldn't. And every year they fail. We hate to see that happen, which is why we typically urge people to be very careful about heading into franchising.

Many of these cautions also apply to established companies contemplating franchising. It's not that franchising is an unusually difficult way of doing business: it's just different.

Of course many shrewd and savvy individuals and corporations have succeeded and continue to prosper as franchisors. Why? What's their secret? That will have to be another question for another day. • • •

ABOUT THE AUTHORS



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As a business growth generalist he has helped numerous companies—from Fortune 100 multinationals to start-ups—investigate and implement franchising and other third-party distribution strategies, and establish successful new or expanded businesses. He has also performed successful turnarounds of troubled companies in the field.

Mr. Janssen has co-authored numerous articles and papers on franchising and related topics.

ADDITIONAL READINGS

The following articles are among those available on the company's website at:

www.janssenellison.com

Some Plain Talk About Franchising

This article is a "must read" for any company exploring the idea of getting into franchising other third party distribution methods. It illuminates some of the dominant fallacies as well as some of the untapped possibilities of franchising as a business method.

The Human Edge in Franchising

Managing relationships is a messy and imprecise business—more art than science. This article characterizes the changing nature of this **human** ***relationship at different stages of the franchise*** **business** ***relationship.***

What Makes a World Class Franchisor?

The seven essential characteristics that true world class franchise companies share.

Issues in Conversion Franchising: An Example

Conversion franchising is one of the most powerful business tools ever created for rapid growth and brand building. Here we explore some of the "ins and outs" of conversion franchising, in this instance as applied to the gasoline and convenience retailing industry.

A Conversion Franchising Fable

This is a conversion "what if" that illustrates what could happen when the right combination of vision and resources come together in a retail industry that's ripe for consolidation. It has happened before and it can happen again.

ABOUT JANSSEN ELLISON COMPANY

COMPANY OVERVIEW

Janssen Ellison Company specializes in business growth and marketing disciplines, particularly third-party distribution methods including various forms of franchising, distributorships, joint ventures and innovative business alliances. Services range from strategic opportunity analysis to complete development programs to conflict resolution to innovative marketing campaigns.

The firm was established in 1988 and has served clients in a wide range of industries. Because each client's needs are unique, the firm's philosophy is to approach each assignment with a "clean sheet of paper" instead of a formula, and to take an active, hands-on, role in helping clients meet their business goals.

REPRESENTATIVE CLIENTS

- Avon
- California Pizza Kitchen
- Cash Plus
- Clean'n'Press
- Franchise Consulting Group
- Futurekids
- General Mills
- Greyhound Lines
- Hard Rock Cafe
- IBM
- Marriott
- Miracle-Ear
- Mobil
- SCORE@Kaplan
- Stride Rite Footwear
- Western Auto
- Westinghouse

FOR MORE INFORMATION

Companies or entrepreneurs interested in learning more about how franchising techniques might be applied in their own setting are invited to contact Jean-Louis Janssen at Janssen Ellison Company.

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