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Franchising- A way to supersize a business?

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Franchising – A Way to Supersize a Business?

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'[In] all the industry related searches among search engines like Google and Yahoo, the search for "Starbucks Franchise" is among the most popular. Yes thousands of people each month for one reason or another go looking for a "starbucks franchise" online. Well, bad news java fans, Starbucks is not a franchise!'[1]

Introduction

When you next visit your favourite McDonalds, Hungry Jacks or KFC – please ponder the complex legal and economic structures that lurk behind the colourful clowns and dearly-departed Southern USA gentlemen. Many of these places are franchises. Have you ever wondered why a Big Mac is fundamentally the same whether you purchase it in Parramatta or Cairns or why the stores look the same wherever you go? Perhaps you work for a franchise. It is worthwhile to understand what franchising is because for many of the activities we undertake every day – and I am not only talking about convenience food – we will be provided with goods and services by someone employed by a franchise. But not all the stores you think might be franchises have gone with that model.

Not all convenience stores are franchises

An interesting puzzle is engaging economists and lawyers from Berkeley to Baltimore.[2] Why does one huge business success story (**Subway**) rely completely on a franchising model, while another (**Starbuck's**) obtains similarly outstanding results almost entirely through a corporate model? Both companies perform well, with high turnover and rates of growth. In fact there are striking similarities between the two companies (please see Table A). What is interesting is that success has been achieved through very different expansion strategies. This article considers some of the reasons why one business might choose to franchise, while another, similarly-situated business may not.

What Sort of Organisational Structure is Involved in Franchising?

What is franchising? The answer depends on the particular jurisdiction. While there may be similarities in definitions of franchising, the differences can be critical. In Australia a franchise has been defined as 'an arrangement under which a person earns profits or income by exploiting a right, conferred by the owner of the right, to use a trademark or design or other intellectual property or the goodwill attached to it in connection with the supply of goods or services.'[3] Effectively, the franchisor grants to the franchisee the ability to sell or distribute products or services which are closely associated with the franchisor's business system, trademark, or other commercial symbol(s). For example if you purchase a Pizza Hut franchise you are aligning yourself with the fit out; procedures; advertising; business model and advertising associated with that franchise. The Franchising Code of Conduct ('the Code') provides a detailed definition of a franchise agreement. (See below).

The essential characteristics of franchising according to the Code are:

1) A grant of the right to carry on the business of offering, supplying or distributing goods or services in Australia under a business system or marketing plan substantially determined, controlled or suggested by the franchisor; and
2) the business is substantially or materially associated with a trade mark, advertising or a commercial symbol of or specified by the franchisor; and
3) the franchisee makes payments to the franchisor.

The Code definition, however lengthy and precise it may be, is broad enough to catch many license or distributorship arrangements. Because businesses have the perception that the Code imposes onerous obligations on the franchisor, some purport to operate within structures that do not fall within the Code definition, e.g. simply as licences, distributorships or managed service agreements.

Why Does a Business Choose to Franchise?

There are many motivations for franchising.[4] The market timing for a viable business concept in a highly dynamic and competitive market must be implemented quickly, due to the

danger of losing market share and brand awareness to others who are ready and willing to copy a good concept.[5] Franchising can help a business to efficiently manage exponential growth by allowing the franchisor to

- Rapidly expand the number of units in the system by raising sufficient capital in minimal time frames,
- Recruit and train qualified, motivated management staff,
- Contain transaction costs such as coordination, motivation and monitoring, and
- Facilitate intra-organisational information-sharing and innovation.

Perhaps the two most important elements in the choice to franchise are 1) capital and resource acquisition and 2) transaction cost efficiency.[6]

1) Capital and resource acquisition:

Franchising helps companies raise capital because franchisees provide both start up and working capital. The new franchisee typically signs a lease, buys plant and equipment, pays for stock and secures the capital to operate the business. In short, the franchisee accepts full financial responsibility for establishing and running the new business unit. In addition the franchisee pays an initial franchise fee as well as royalties and other various ongoing service fees. In this way the franchise structure offers a uniquely effective method of harnessing the equity of many franchisees to 'turbo-charge' rapid expansion and market penetration for the franchise system. In return each franchisee receives a piece of a successful business concept and can operate the franchise business for the term of the grant of the license at the designated location(s).

2) Transaction cost efficiency :

The reduction of transaction costs is another important motivation for the franchise structure.[7] Transaction costs include any costs incurred in business relationships other than physical or technological costs of production. Certain business relationships minimise the transaction costs of producing and distributing a particular good or service.[8]

The franchising form allows the franchisor to enter into an employment-like relation but with lower costs and risks than those associated with employment. Perhaps what is most significant about transaction cost theory for franchising is that the franchisee's equity investment ensures a strong commitment to the success of the business. Most franchisees directly manage their businesses themselves (and are often required to do so according to terms of the contract). The level of motivation of a typical franchisee is rarely if ever achieved by employed staff. Franchising reduces the costs of monitoring the performance of the management of multiple outlets in diverse locations by giving the ultimate monitor, the franchisee, a residual claim over the profits of the unit.

The franchisor can achieve economies of scale (and accordingly savings) in purchasing, product development, advertising and marketing. Freed of day-to-day unit operation, the franchisor can concentrate on the larger issues of growing the system. Other economies in transaction costs are, for example, that the per-unit cost of developing a franchise system is often less than the amount required to open one additional company store. Also, purchasing of supplies, advertising and other services can become more cost effective as a franchise group expands.

Why Does a Franchisee Buy a Franchise?

Many factors can contribute to the appeal of franchising to the franchisee. Such factors include claims that franchis-

Table A: Coffee and Sandwiches: More in Common than You Might Think

	Starbucks	Subway
Founded	1971 in Seattle's Pike Place Market, Seattle, WA	1965 in Bridgeport, CT
U.S. Locations	5,000 company-operated 2,600 licensed locations	22,000 units
International Locations	In 36 countries outside of the United States	In 82 countries outside of the United States
	Company-operated: 1200	3000 international locations
	Joint Venture and licensed locations: 2000	
Annual Sales	US$6.4 billion	US$9.5 billion
Website	http://www.starbucks.com	http://www.subway.com
Form of Expansion	Corporate	Franchising
	Starbucks does not franchise to individuals. However, in situations in which a master concessionaire or other company controls or can provide improved access to desirable retail space, the Company may consider licensing its operations.	Virtually all SUBWAY® restaurants are franchised. One company-owned unit is operated as a testing facility.

(all figures are as of latest publicly released information as of 15 Feb 2006 and are rounded to nearest hundred or thousand) ing offers the franchisee the following benefits:

- Tried and tested business system,
- Existing successful name and reputation to increase chance of success; there is a widespread belief that a new business is more likely to survive as a franchise than as an independent operation,[9]
- Track record of the system that helps assess prospects for performance,
- Small entrepreneurs can compete with national and international firms,
- Management support, training, and technical assistance,[10]
- Externally-imposed discipline,
- Collective marketing and advertising,
- Better cooperation from lenders,
- A route into self-employment without prior self-employment experience,
- Job satisfaction and easier business development.[11]

As well as commercial and economic considerations, the appeal of franchising to prospective franchisees can be attributed in part to cultural and socio-political factors. The rise of the entrepreneur to the status of a cultural icon benefits franchising, as franchising can encompass values of entrepreneurial individualism, freedom and cooperation that are admired in many cultures. Franchising offers franchisees an opportunity to realise cultural ideals such as autonomy, independence, material rewards, entrepreneurship, creativity, and flexibility, but with perceived levels of risk that are much lower than starting a new business independently. In franchising, independence and autonomy coexist, though sometimes uneasily, with security and employment. Relatively recently, 'lifestyle franchisees' (e.g. mothers with school-aged children and retirees) have been identified as being particularly attracted to the flexibility and independence of the structure.

So why does Starbucks not franchise at all, instead relying entirely on company-owned stores and licensing, while Subway franchises all but one of its 22,000 stores?

The similarities between Starbuck's and Subway as shown in Table A would suggest that similar business structures would be appropriate for both enterprises.

Despite the similarities between the two businesses, as the last line in Table A shows, they chose different approaches to growth. Their respective success suggests that there is not a right and wrong answer to the question of whether or not to franchise a business.

According to interviews with their respective founders, both Subway and Starbuck's selected strategies to ensure that their employees would identify with the company and feel a vested interest in its success. Starbucks did it with training and stock options; Subway used franchising to ensure its managers had an equity interest in each store's success.

Subway founder, Fred DeLuca, chose franchising to tap into individual's 'entrepreneurial spirit'. Franchising also makes it easier to open stores across many markets simultaneously because "the investment you need as a company to expand geographically isn't as great and because we're a relatively cheap company to get a franchise in."

Reasons for Subway's choice of the franchise structure cited in interviews were:

1) Capital inefficiency, where the franchisor may encounter difficulties in securing adequate financing on attractive terms over long period of expansion in diverse markets (see above), and
2) The franchise structure can allow reduced reliance on public ownership so that the system does not need to sacrifice control to investor interests (Control over the alternate source of capital, the franchisee, is handled through mechanisms such as contract and operations manual).

Starbuck's founder, Howard Schultz, believes company-owned stores can better engender shared company values. At the same time, they offer flexibility: "You can read the marketplace and turn on a dime." Company ownership also means that the system can expand or develop new revenue sources without the problems of territoriality, exclusivity and encroachment that recur in franchising. The company can more easily expand in a single metropolitan area. As Subway's DeLuca admits "the process of finding hundreds of franchisees on one city can be hard."

Other possible reasons for the choice of the company-owned structure for Starbuck's might include:

1) The difficulty in attracting sufficient number of qualified franchisees to meet Starbuck's growth projections, and
2) The fact that Starbuck's saturation strategy is inconsistent with territoriality and exclusivity guarantees to franchisees.

Finally, Starbucks management also decided that the level of expertise and training for their *barristas* (the people who make the coffee) required company ownership.

[Mr. Schultz, may I make a personal observation here? Having bought coffee in Starbucks stores in London, Shanghai, New York and Sydney, I would have said the expertise involved was no greater than at your average Mcdonald's in any of those cities. I have also bought a few Subway sandwiches in my time, and, to be honest, I'd guess that working with me through the custom construction of my Toasted Vegetarian Pizza Deluxe Subway® sandwich would require greater up-front training (not to mention at a session or two of counselling afterward)]

Business Organisations Custom-Made to Order

The choice of whether to franchise, to operate company-owned stores, a mix of the two, or something else altogether, is a choice based on economic, marketing, management and legal considerations. Legal considerations include the nature of local regulatory regimes, including intellectual property protection, competition law, tax laws, and sector-specific regulation, if any exists. In international expansion, for example, diverse local government laws or requirements for foreign investment may dictate certain strategies. Once the choice is made, the legal ramifications are extensive, including the drafting and negotiation of contracts, licenses and leases; the nature of relationships, e.g. with franchisees and store managers; relations with creditors, consumers, suppliers and other third parties, such as insurers.

Annexure

(Industry codes – Franchising) Regulations 1998 – Schedule Franchising Code of Conduct, Reg 4 (1).

(1) A *franchise agreement* is an agreement:
  (a) that takes the form, in whole or part, of any of the following:
    (i) a written agreement;
    (ii) an oral agreement;
    (iii) an implied agreement; and
  (b) in which a person (***the franchisor***) grants to another person

(***the franchisee***) the right to carry on the business of offering, supplying or distributing goods or services in Australia under a system or marketing plan substantially determined, controlled or suggested by the franchisor or an associate of the franchisor; and

(c) under which the operation of the business will be substantially or materially associated with a trade mark, advertising or a commercial symbol:

(i) owned, used or licensed by the franchisor or an associate of the franchisor; or

(ii) specified by the franchisor or an associate or the franchisor; and

(d) under which, before starting business or continuing the business, the franchisee must pay or agree to pay to the franchisor or an associate of the franchisor an amount including, for example:

(i) an initial capital investment fee; or

(ii) a payment for goods or services; or

(iii) a fee based on a percentage of gross or net income whether or not called a royalty or franchise service fee; or

(iv) a training fee or training school fee; but excluding:

(v) payment for goods and services at or below their usual wholesale price; or

(vi) repayment by the franchisee of a loan from the franchisor; or

(vii) payment of the usual wholesale price for goods taken on consignment; or

(viii) payment of market value for purchase or lease of real property, fixtures, equipment or supplies needed to start business or to continue business under the franchise agreement.

(2) For subclause (1), each of the following is taken to be a franchise agreement:

(a) transfer, renewal or extension of a franchise agreement;

(b) a motor vehicle dealership agreement.

(3) However, any of the following does not in itself constitute a franchise agreement:

(a) an employer and employee relationship;

(b) a partnership relationship;

(c) a landlord and tenant relationship;

(d) a mortgagor and mortgagee relationship;

(e) a lender and borrower relationship;

(f) the relationship between the members of a cooperative that is registered, incorporated or formed under any of the following laws:

(i) *Co-operatives Act* 1992 of New South Wales;

(ii) **Co-operatives Act 1996** of Victoria;

(iii) *Cooperatives Act 1997* of Queensland;

(iv) *Co-operative and Provident Societies Act 1903* ofWestern Australia;

(v) *Co-operatives Act 1997* of South Australia;

(vi) *Co-operative Industrial Societies Act 1928* of Tasmania;

(vii) *Co-operative Societies Act 1939* of the Australian Capital Territory;

(viii) *Co-operatives Act 1997* of the Northern Territory;

(ix) the Corporations Law.

A list of franchises you might not know about:

Hungry Jack's
Helen O'Grady Children's Drama Academy
The Coffee Club
Signwave
Elite Fitness Equipment
Red Rooster
Bartercard
Michel's Patisserie
Lenard's
Boost Juice
Poolwerx
H&R Block
Mortgage Choice
Ella Bache
Fernwood Women's Health Club
Jim's Mowing (and other services)

. . . and hundreds more . . . for a partial listing and for information about franchising in Australia generally see the Franchise Council of Australia website at http://www.francbisebusiness.com.au

1 http://www.mysitespace.com/franchise_opportunities/starbucks-franchise.asp

2 See discussion at http://www.professorbainbridge.com/2003/12/the_starbucks_v.html

3 Ken Robson, *Robson's Annotated Corporations Act 2002* (2002), 92. There is no mention of a fee in the Corporations Act (Cth 2001) definition although there is a fee as an element of a franchise in the Franchising Code of Conduct.

4 For a thorough review of theories of franchising see Mehta, S.S. and Pelton, L. E., 'Limitations of Existing Theories: A Need for a General Theory of Franchise Relationships', *International Society of Franchising*, (2000).

5 As opposed to 'first mover' theory, the idea that it is better to be second in a market with a new idea than the first.

7 Oliver Williamson, *Markets and Hierarchies: Analyses and Antitrust Implications* (1975); Oliver Williamson, *The Economic Institutions of Capitalism* (1985).

8 This approach sometimes goes under the rubric of 'New Institutional Economics', a version of 'Neoclassical Economics'. The "new" institutional economics derives human-made institutions from individual tastes (or preferences) and technical or natural factors, such as transaction costs. Some of the authors associated with this school include Ronald Coase, Oliver Williamson, and Douglass North. See Wikipedia (2005) *Wikipedia: Free Online Encyclopedia* http://en.wikipedia.org/wiki/Institutional_economics

9 Franchising is widely reported to as much as double the chances of success, but it is not clear to what extent the figures are a product of marketing efforts by franchisor organisations insufficiently supported by empirical data.

10 In fact, franchisors want to avoid offering this and other services unless they generate additional fees; the trend is to make it an ancillary contract.

11 Vance H. Fried, B. Elango, Franchising research: a literature review and synthesis (July 1, 1997) *Journal of Small Business Management*, 71-72.

Class Exercise:

You could visit your local franchise i.e. McDonald's; Pizza Hut or Hungry Jacks and ask the manager what advantages using a franchise might provide.