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Feature

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Turning to franchising in troubled times

While all business models are likely to suffer in times of recession, the franchising model is predicted to fare better than most in terms of growth. Other immediate benefits make it an option brand owners should consider

It's a well-worn joke: Two hikers confront a hungry bear on the trail. As the first hiker turns to run, the second hiker drops to the ground, throws off his boots and pulls out a pair of running shoes. The first hiker says: "Are you crazy? You can't outrun a bear with those shoes!" To which the second hiker replies: "I don't have to outrun the bear. I only have to outrun you!"

In the context of the troubled worldwide economy, franchising is the second hiker and general business is the first. While the hungry bear nips at the heels of businesses large and small, franchising as a sector, though also in danger, runs ahead in a somewhat less vulnerable position. This article considers the performance of franchising in the current recession and the reasons why brand owners might look to franchising as a business model for an economy in recession.

Franchised business economic outlook

In January 2009 the International Franchise Association (IFA), based in Washington DC, released its first-ever report projecting economic performance of business format franchises in the United States for a single year. The IFA's Educational Foundation commissioned the report from international accountancy firm PricewaterhouseCoopers (PwC). PwC's forecast addressed the number of establishments, employment and economic output for 10 business lines in which franchising is prevalent:

- quick service restaurants (QSRs);
- table/full service restaurants;
- retail food;
- lodging;
- real estate;
- business services;
- personal services;
- automotive production;
- commercial and residential services; and
- retail products and services.

Not surprisingly, PwC projected downward trends for 2009 in all three measured categories:

- a decrease of 1.2% in the number of establishments – or about 10,000 establishments – versus growth of 2.1% in 2007/2008 and average annual growth of 5.6% from 2001 to 2005;
- a decrease in employment of 2.1% – or 207,000 jobs – versus a slight decline of 0.2% in 2007/2008 and an average annual increase of 3.7% from 2001 to 2005; and
- a reduction in economic output (gross value of goods and services produced) of 0.5% – or $4.2 billion – versus 2.8% growth in 2007/2008 and average annual growth of 9.7% from 2001 to 2005.

PwC's projections, however, were not negative for all 10 sectors studied. For QSRs and table/full service restaurants, PwC forecast positive growth in the number of establishments, employment and output.

Consistent with the PwC forecast, on February 9 2009 McDonald's Corporation announced that its global comparable sales increased 7.1% in January (5.4% in the United States, 7.1% in Europe, and 10.2% in Asia-Pacific, the Middle East and Africa). ('Comparable sales' means sales at restaurants that have been open at least 13 months against the same period in the prior year.) Anecdotally, the authors can report that they are aware of at least two other food service franchises whose sales have increased significantly in recent months (the brand owners are private companies that do not release financial data).

Overall, we believe that the trends for franchised brands in the current recession match the trends for brands generally. That is, both franchised and non-franchised brands are performing well if poised to capture consumers who are seeking to trade down to less expensive alternatives (eg, McDonald's and Wal-Mart). Both franchised and non-franchised brands are struggling if they offer luxury purchases that can be deferred (eg, home remodelling projects and hotel stays).

Still, there is a sense that franchising generally has done better than the US economy as a whole in the current recession. An IFA Franchise Business Leaders Survey conducted in November 2008, released together with the PwC report, showed that while only one-quarter of the survey respondents believed that the economy will do better in 2009 than in 2008, nearly half believed that their own franchised businesses will do better in 2009.

Franchising in recessionary times

The conventional wisdom about franchising is that it is counter-cyclical. Indeed, the dot-com boom of the late 1990s was a challenging time for franchisors because of high employment, the lure of stock options and the resulting shrunken pool of qualified franchise candidates.

Quick service restaurant and cheap retailer brands are performing well in a downturn

The recession of 2000-2001, caused by the bursting of the dot-com bubble and the tragic events of September 11 2001, stimulated franchising activity. Laid-off employees, flush with business experience and some accumulated net worth, sought employment alternatives. Also, credit was available. The result was that franchising created more than 140,000 new businesses and 1.2 million new jobs in the following five-year period in the United States. These figures come from another PwC study done for the IFA called the "Economic Impact of Franchised Businesses Volume 2" (February 2008). The report documented that franchising grew at a faster pace than many other sectors of the economy from 2001 to 2005, expanding by more than 18%.

But things are a bit different this time around. Franchise development pipelines are currently at a trickle. Development officers cite hesitancy by prospective franchisees and lack of access to capital to fund a unit. Rising unemployment, which in past recessions had filled the pool of attractive franchise candidates, so far has not been of as much help. The laid-off employees of 2008 and 2009 are receiving smaller severance packages and their personal assets (home equity and retirement funds) have been hit hard by the financial markets. With less of a financial cushion and shaky economic forecasts, potential franchisees are less willing to risk the investment. And just when they are in greater need of external capital, access to it has become a major obstacle.

Advantages of the franchising business model

So why should brand owners think that the franchising business model can help them climb out of the downturn? Here are some of the reasons:

Potential franchisee communities: Franchise brands attract two important communities of investors besides laid-off employees. One of them is the community of multi-unit operators – those who own multiple outlets of one or more franchise concepts. This group has a built-in incentive to expand into other geographical markets as they exhaust opportunities or even to expand into other (presumably non-competing) brands. They also have a greater ability to develop units in this capital-starved climate, because they offer a twin risk-reduction benefit to bankers: not only are they experienced operators, but often they are affiliated with a brand with which the banker already has experience.

The other community consists of independent business operators not affiliated with a franchise brand. In a recession, some independent operators seek the relative safety of an established brand, especially in certain industries such as lodging. These 'conversion' franchisees can be difficult to integrate and their level of commitment must be carefully screened, lest economic recovery generate remorse for surrendering some control to join the franchise network. Nevertheless, they may offer brand owners tantalizing new markets and desirable locations, not to mention a track record of business experience.

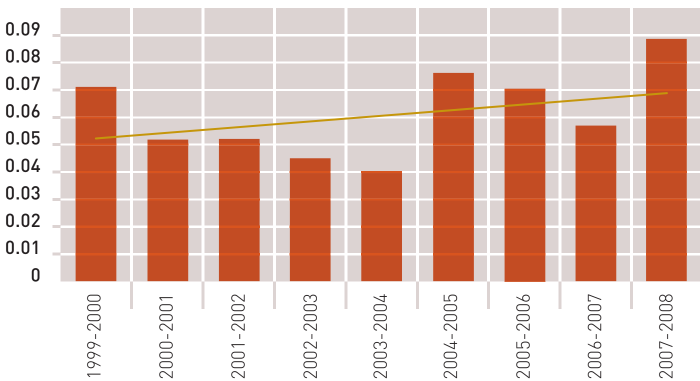
Wider financing alternatives: As noted above, franchise brands have an advantage in prying free the few funds that banks are willing to lend at present. In some cases bankers will have previously done due diligence on the brand for other transactions; they know that the franchisor stands behind the brand; and their loans to borrowers affiliated with the brand will have a performance history.

Moreover, the US Small Business Administration (SBA), which manages financing programmes for the development and growth of small business enterprises, has a special mechanism to facilitate lending to franchise brands. The SBA Franchise Registry is a list of franchise concepts whose documents have been pre-screened for eligibility for the agency's loan guarantee programmes. The registry

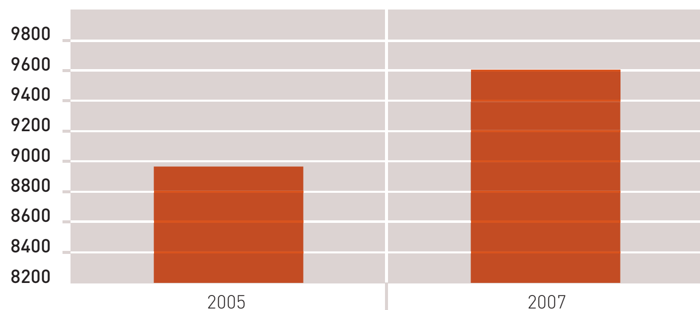
Annual percentage increase of US franchise units (1999 to 2008) per industry sector

Industry	1999-2000	2000-2001	2001-2002	2002-2003	2003-2004	2004-2005	2005-2006	2006-2007	2007-2008
Automotive	4%	-4%	-4%	3%	-1%	2%	4%	-2%	0%
Business Services	12%	5%	6%	-3%	4%	8%	13%	3%	6%
Commercial & Residential Services	6%	5%	2%	3%	2%	4%	6%	5%	8%
Food Retail	4%	6%	5%	3%	4%	2%	3%	6%	8%
Lodging	12%	5%	3%	1%	0%	2%	3%	1%	3%
NEC – not elsewhere classified	5%	12%	13%	7%	8%	42%	27%	19%	21%
Personal Services	6%	11%	15%	17%	11%	7%	3%	10%	13%
Quick Service Restaurants	10%	4%	5%	6%	5%	5%	4%	4%	6%
Retail Products & Services	1%	3%	2%	3%	2%	1%	4%	5%	8%
Table/Full Service Restaurants	13%	6%	5%	5%	6%	5%	4%	5%	7%
Average	**7%**	**5%**	**5%**	**5%**	**4%**	**8%**	**7%**	**6%**	**8%**

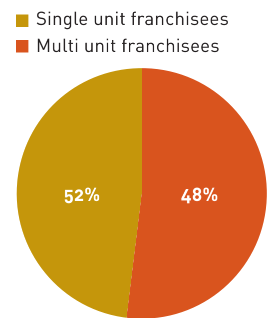
Industry classification



Annual percentage increase of US franchised units (1999 to 2008*)



Precentage of units controlled by franchisee type (United States, 2007)



Source: **FranData www.frandata.com**
*** Estimated**

> **"Because the brand owner is not committing its own assets to franchised markets, the brand owner is much freer to respond to opportunities wherever they arise"**

> **“Franchisees have been more receptive to franchisor input and leadership, enhancing the brand owner’s ability to set and implement a consistent strategy for the brand”**

expedites SBA loan processing because lenders can skip review of the franchise documents in the loan application process.

Another advantage of franchising is its popularity with private equity funds. In the past 10 years fund managers have become enamoured with the franchising business model and have invested on both the franchisor and multi-unit franchisee side. Though private equity funds depend on leverage to generate their target returns and are therefore constrained by the current lending environment, many of them are sitting on a war chest of cash that can be deployed in brands that meet their favour.

Network benefits: Just as a rope is far stronger than its individual strands, a franchise brand benefits from the interdependency of the franchisor and franchisees in times of external stress. A widely recognizable name, robust training system, economies of scale in purchasing and opportunities for internal benchmarking are among the ‘network effects’ (in economist language) that give a franchised brand competitive advantages in an economic downturn, compared to a collection of independent operators.

Team mentality: The psychological impact of the ‘team mentality’ in a franchise network should not be underestimated. The past year has seen an attitude adjustment on both sides of the franchise relationship. Franchisors are scrutinizing unit-level economics with a passion not seen in years, working with their franchisees to address operational inefficiencies and improve their bottom line. For franchisees who are in serious financial difficulty but capable of a turnaround, franchisors have been generous with royalty abatements or deferrals and in supporting efforts to restructure with landlords and lenders. Franchisees have been more receptive to franchisor input and leadership, enhancing the brand owner’s ability to set and implement a consistent strategy for the brand. Both parties have been more willing to share data to develop best practices and compare performance against other franchise systems.

While it is possible that the team mentality will diminish when better times return, we think that the shared trauma of the current economy will have a lasting effect on franchise relationships – like soldiers returning from war or the shared attitudes of those who lived through the Great Depression. In 2009 we will see separation between the better operators and brands, and the weaker operators and brands. Marginal performance which went unnoticed during the rising tide of the last few years will be uncovered, with pain for some in the short run, but for the good of the franchising business model over the long term.

Flexibility and innovation: The franchising business model gives the brand owner considerable flexibility and promotes innovation in the branded products and services – qualities important in any business climate but critical in a time of recession. Because the brand owner is not committing its own assets to franchised markets, the brand owner is much freer to respond to opportunities wherever they arise. This is a huge advantage in an environment that is creating rare opportunities to seize control of prime business sites. On March 31 2009 the *Wall Street Journal* reported on franchised restaurant chains that are jumping on the opportunity to move into vacated locations. Executives of franchised brands such as Buffalo Wild Wings, Panera and Burger King quoted in the article cite the opportunity to convert closed locations at a lower cost than building from scratch, as well as the current bargaining power with landlords.

The franchise business model is also readily adaptable to different ownership and development structures, some of which have been discussed above. The model accommodates everything from mom-and-pop, single store operators to private equity-backed multi-unit operators that undertake a market build-out commitment.

Innovation is an inherent characteristic of franchise systems that shines when research and development budgets are tight. It has become legend that some of the best-known products of franchised brands, such as McDonald’s Egg McMuffin, were originally conceived by franchisees. A time of recession is a time of fertile thought and invention to attract and retain customers, and franchised units, subject to appropriate franchisor controls, act as a network of testing laboratories that can generate ideas for the brand.

Bottom line

Franchising as a mature industry, or at least as one mature in a wide variety of business lines, has not been around for many recessions. The evidence to date supports, though does not fully validate, conventional wisdom: franchising is clearly not recession-proof, but does appear more resistant than business in general. The attributes of the franchising business model described above may help explain why franchising does a little better and offers an appealing strategy to brand owners in the current business climate. Hikers, put on your running shoes – you can still outlast that bear. WTR

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