By David W Koch and Darrell M Johnson

Weathering the storm – assessing the resilience of the franchise model

In 2009, *WTR* presented an assessment of the franchise model and predictions of how it would fare during the recession. Three years on, the authors revisit the market, considering how their predictions fared and what has been learnt about the franchising business

It is March 2012 and the cherry trees are blooming early in Washington, DC – perhaps alarmingly early. So too does the US economy seem to be blooming; and yet memories of the 'Great Recession' are fresh and vestiges of it remain.

In the midst of the downturn, we wrote an article for this publication highlighting the advantages of the franchise business model that we believed would enable franchise brands to weather the economic storm better than businesses generally ("Turning to franchising in troubled times," *WTR,* June/July 2009). Were we right? What lessons have the last three years laid down for the role of franchising in the economy?

In this follow-up article, we re-examine the perceived business advantages of franchising with the benefit of hindsight. First we look at how franchising has performed economically in the United States over the last few years, and at the outlook for its performance in 2012. Then we revisit the purported advantages of franchising to assess whether they have proved fact or fiction since 2009.

Recent economic performance of franchising

As we anticipated, franchising seems to have fared better than business generally in the downturn. No one would contend that the period since 2009 has been spectacular for franchising, but the statistics show that franchising at least held its ground, while other business sectors shrank. Figure 1 tracks the performance of a basket of franchise-related stocks assembled by FRANdata, the FRANdex index. As Figure 1 shows, the franchise index has outperformed the broader stock market indices since the first quarter of 2009.

Unsurprisingly, the growth rate in the number of new franchise brands in the United States slowed dramatically in the 2006-2010 period, compared to 2000-2005. The compound annual growth rate for 2006-2010 was only 14% compared to a brisk 71% for 2000-2005. Still, growth is growth, and better than the alternative. As shown in Figure 2, a significant number of new brands began franchising in 2009, 2010 and 2011, despite the downturn and lingering economic uncertainty.

Growth also slowed dramatically on the unit level, slipping from almost 16,000 new units in 2009 to fewer than 13,000 in 2010 (see Figure 3). At the same time, continuity – the proportion of new franchised units that continued in operation in the same location– turned upwards in 2010, perhaps reflecting a shift of attention towards helping existing units to operate better. To be clear, the opposite of continuity - discontinuity – does not imply failure *per se*. While failed units are in the discontinuous percentage, so too are units that simply moved to a new location or closed for reasons other than financial failure. However, over time, the continuity rate is a good measure of comparative system performance. The reduced appetite for franchise purchases during the recession gave franchisors both the time and the incentive to refocus on unit-level success over additional units.

The performance of franchising varied by sector, reflecting the broader US economy. As would be expected, franchising concepts with the closest links to the most troubled economic sectors – housing, automobiles and financial services – saw declines in unit numbers during the recession, led by franchised residential real estate concepts (see Figure 4). Meanwhile, franchising concepts in other sectors saw substantial new unit openings in the midst of recession.

Overall, franchised unit numbers plateaued in 2009 and 2010, suggesting that improved continuity plus new unit openings in the positive sectors offset closings in the troubled sectors. Figure 5 provides an overview of total franchised units.

Outlook for 2012

The International Franchise Association (IFA) Educational Foundation commissions annual reports on the economic outlook for business format franchises in the United States. The latest report, prepared by IHS Global Insight, projects that in 2012 the number of franchise establishments in the United States will increase by 1.9%; franchise business employment will increase by 2.1%; and output of the franchise sector will grow by 5%. Lodging, business services and personal services are expected to see the most growth in 2012, according to the report.

These are modest growth projections, to be sure, but they have turned out to be harbingers of improvement in the broader economy. For example, the Labour Department's monthly jobs report for February showed that 227,000 new jobs were created that month. In a March 9 release, IFA president and chief executive Steve Caldeira noted that the report tracked with the franchise industry's projections and included job increases in key franchise sectors, such as business services, personal services, retail, restaurants and healthcare, reflecting "the overall improved sense of optimism from franchise businesses in 2012". However, he also cautioned that while the jobs report was "another positive sign that the economy is recovering, the franchise industry is still not growing at pre-recession levels" – a fact that he attributed to "uncertainty over tax rates and a variety of regulatory issues impacting the small business lending environment that is so critical to franchise business growth".

Franchising advantages revisited

In our 2009 article, we highlighted five reasons why the franchising business model might help brand owners to weather the downturn. Some of our observations have been validated, while others have had mixed or less clear results.

Advantage 1: potential franchisee communities

We noted that franchise brands might have a better chance than most to grow during the recession because of their potential to attract two groups of highly capable investors: existing multi-unit operators looking for geographic or business line expansion, and existing independent operators looking to convert to an established brand for safety.

Were we right? We were at least half right. In recent years, multi-unit operators have increased their share of unit ownership overall from 51% to 53% - perhaps not so much strategically for diversification or geographic reach, but simply in response to opportunity. Less efficient and sometimes struggling single-unit operators have increasingly put their businesses up for sale, and existing same-brand multi-unit operators have been the most ready buyers, facing little competition from those who might have bid more actively in better times: other single-unit operators, the seller's store manager or family members, and the franchisor itself. But brand diversification by multi-unit operators is also in the mix, as illustrated by a transaction just announced on March 13: the acquisition by NRD Holdings, LLC, which operates the Popeyes and Dominos franchises, of Frisch Restaurants, Inc's Golden Corral franchise. Today, there is greater concentration of units by larger multi-unit operators, as Figure 6 shows.

There is also evidence of an upswing in 'conversion' franchising, though numbers of actual conversions are hard to come by. In April 2011 The Dwyer Group, a franchisor of several trade services brands, announced a programme to help independent plumbing, electrical, heating/cooling, restoration, appliance service, glass replacement and landscape management companies to convert their businesses to one of The Dwyer Group's concepts. The company touted the franchise system benefits of national buying power and marketing support, and offered funding of anticipated conversion costs. Conversion franchising has also been suggested as a method to tap the benefits of tax-deferred exchanges, with the deferred taxable dollars essentially representing an interest-free loan that the conversion franchisee can access without regard to the tightening of bank credit.

The franchising model is also directly responsible for the rise of another group of highly capable investors since 2009 – one that we did not mention in the previous article. That group is professional athletes. Although not a completely new phenomenon, franchising investment by professional athletes has ramped up significantly. For example, on February 24 2012 the IFA and the Professional Athlete Franchise Initiative (PAFI) announced a strategic alliance with the National Basketball Retired Players Association. This follows on a series of efforts between the IFA and PAFI, as well as by others, to introduce professional athletes to franchising.

Advantage 2: wider financing alternatives

We anticipated that franchise brands would do better than businesses generally in attracting capital from banks (in part because of Small Business Administration programmes for franchising), as well as from private equity companies.

Again, we were partly right. Based on anecdotal reports from our

Figure 1: FRANdex

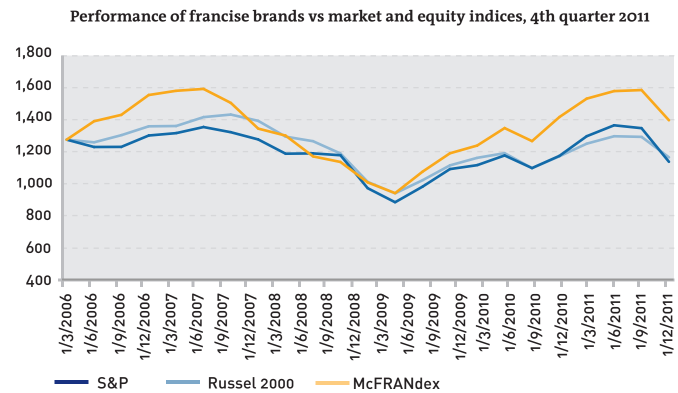


Figure 2: Growth of new franchise brands

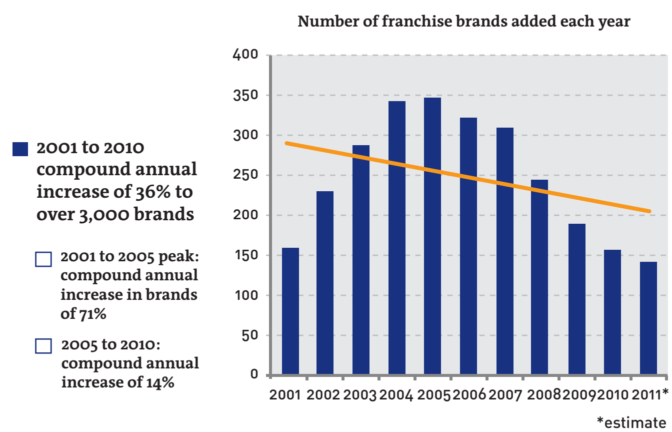
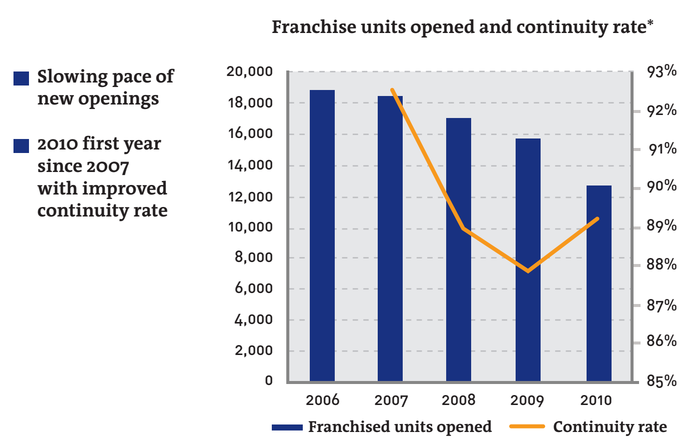


Figure 3: Franchise units opened



> **"There is one clear example where the flexibility of the franchising model has conferred an advantage in the last two years: international expansion"**

Figure 4: Franchised unit growth/decline over most current five years

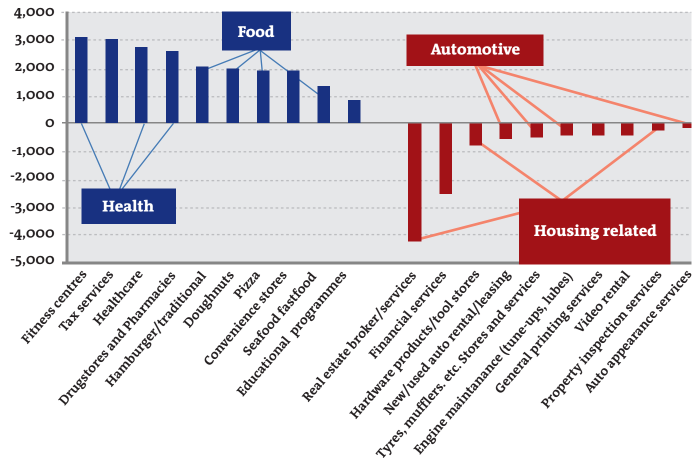


Figure 5: Franchised unit numbers

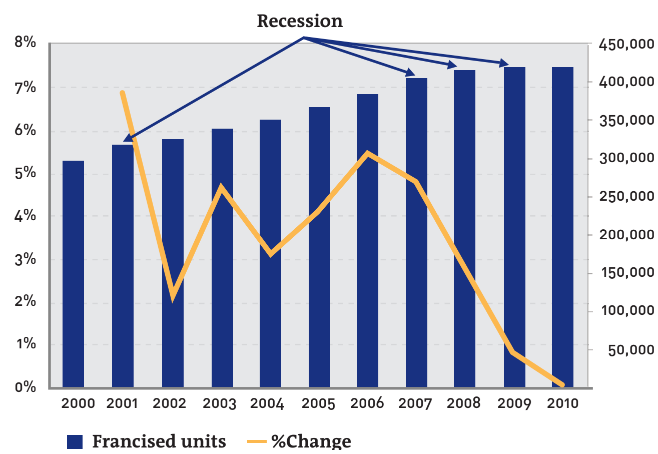
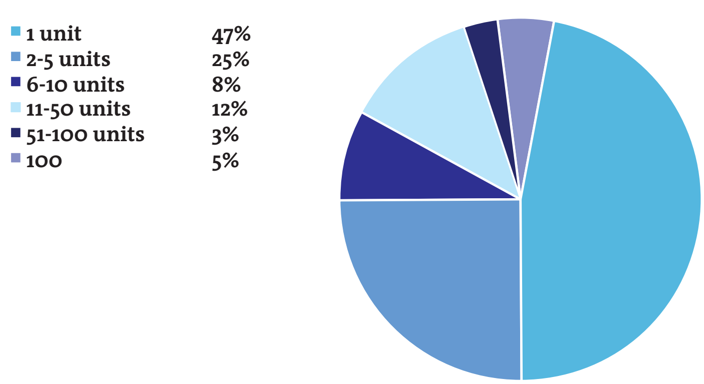


Figure 6. **Percentage of franchised units controlled by franchise type**



clients, bank lending to franchisees has loosened up since 2009, but only incrementally. For example, according to research reported in *Nation's Restaurant News*, chain restaurant loan originations showed an uptick in 2010 and 2011, but were still below 2008 levels. However, we cannot say that the loosening, such as it is, has been any greater or faster for franchising than for business generally. We believe were are right, but perhaps just a bit ahead of results that appear to show a relatively greater flow of capital to franchised small businesses. From a lending standpoint, franchising has a big advantage over other small businesses – performance history. Each franchise brand can be analysed in the context of a credit profile - some good, others not so good. Banks are beginning to understand the availability of information, most notably franchise bank credit reports, which provide important risk measures around individual unit, whole system and franchisor performance. Banks are starting to demand and franchisors are increasingly arranging to deliver this information. With a deeper level of information with which to make credit decisions, there is growing evidence that franchise systems are attracting a greater flow of capital than non-franchised small businesses.

As to private equity, however, we were right on the money. We both attended The Capital Roundtable's October 27 2011 conference entitled "Private Equity Investing in Franchise Companies", at which Darrell was a keynote speaker and presented FRANdata's research on the recent impact of private equity in franchising. His data and numerous reports of private equity deals in the franchise trade press make clear that the franchising business model attracts investor money. In fact, the point was made by more than one private equity and investment banking representative at the conference that franchise brands attract higher multiples of earnings before interest, tax, depreciation and amortisation than non-franchised companies.

Moreover, franchise brands have expanded financing alternatives in ways that we did not mention in 2009. For instance, mid-sized and large franchisors have taken it upon themselves to partner with lending sources to improve franchisee access to financing. The above-mentioned *Nation's Restaurant News* article highlights partnerships by Denny's and Wingstop with major lenders to create loan pools for their franchisees, as well as an innovative programme by Marco's Pizza to use personal guarantee insurance to make loans more attractive to banks. These brand-focused efforts give business owners operating under a franchise model a leg-up over those who are not.

Advantages 3 and 4: network benefits and team mentality

We speculated in the previous article that franchise network benefits, such as economies of scale in purchasing and internal benchmarking opportunities, would give franchised brands a competitive advantage in the downturn. We also envisioned that a 'we're in this together' attitude would focus franchisor attention on unit-level economics and promote franchisee receptivity to franchisor leadership, brand strategy and benchmarking with other franchisees.

Our impression is mixed as to whether the franchising model has delivered these perceived advantages since 2009. On the positive side, we have seen public announcements of initiatives such as the franchisor-sponsored conversion and financing programmes discussed above. *Nation's Restaurant News* recently reported on Sonic's efforts to capture network benefits, including by moving its media buying from a regional to a national agency to improve the effectiveness of marketing dollars and by developing a less expensive small-building prototype. Anecdotally, we know from our franchise clients of their efforts to trim unit-level operating costs and work with distressed franchisees on a recovery or graceful exit. But we cannot correlate this anecdotal data to a general statement that the franchising model has performed better than businesses generally. We would need data, for example, comparing the purchasing costs for franchisees with the costs incurred by non-franchised operators in the same period.

On the negative side, the financial stresses of a recession can lead to conflict in a franchise system, and recent experience is no exception. A recent *Wall Street Journal* article noted "a growing rift between franchisees and franchisers" in focusing on lawsuits filed by franchisee groups in three systems (Cold Stone Creamery, Burger King and Edible Arrangements) since 2009. The issues in the lawsuits vary, but they all involve issues of trust (alleged abuse of franchisor discretion regarding advertising funds, vendor rebates, system-wide value pricing and hours of operation). In fact, the flavour of the allegations is that the franchisor has rejected the notion that 'we're in this together' and instead acted in its own self-interest, without regard to franchisee profitability. These business owners, at least, might say that the franchising business model has been no advantage in the downturn.

Advantage 5: flexibility and innovation

We thought that the franchising business model would position franchisors and franchisees to respond more nimbly than other businesses to market opportunities in a recession. We also hypothesised that an inherent characteristic of franchise systems – their capacity to generate innovation from independent business owners – would play into the recession's demand for ideas to attract and retain customers.

This is another area where it is difficult to measure the performance of the franchising model against the performance of non-franchised businesses. However, there is one clear example where the flexibility of the franchising model has conferred an advantage in the last two years: international expansion. Franchising activity by US brands in India, China and other faster-growing markets continued apace, or even accelerated, when the downturn slowed business development at home. We credit that manoeuvrability among opportunities at home and abroad to the 'asset-lite' nature of franchising, along with its reliance on the local market expertise of the foreign franchisee.

There is also recent evidence of the way in which the franchising model facilitates the spread of innovation. QSRWeb, for example, recently reported on a three-unit McDonald's owner/operator who has developed (with a vendor) a nutritional kiosk to address menu labelling requirements. The kiosk includes a 42-inch touchscreen that enables customers to review nutritional information for the entire menu and to use a "Build Your Meal" tool to see the total nutritional breakdown of their selections. According to the franchisee, "My phone hasn't stopped ringing. So many operators want to know how they work and how customers have responded." This is a classic example of one franchised unit serving as a test lab for all other franchised units, all of which then share (along with the franchisor) in the innovation – to which they would not have access if they were not related by the franchise brand.

The Great Recession refuted the notion that franchising is 'recession-proof', but in our view it confirmed that franchising is 'recession-resistant'. By 'resistant', we mean that franchising seems to have suffered less than businesses generally in the downturn and to have moved back towards positive territory a little sooner. The available data, at least, points to these conclusions. Whether responsibility is due to the advantages of franchising that we proffered in 2009, however, is a more difficult question. Additional and more complicated factors may be at work, and their effects will vary among the types of business in which franchising is used. But we continue to believe that the advantages of franchising are real and should be top of mind when recession comes again. WTR

David W Koch is a founding partner of Plave Koch PLC, a Reston, Virginia law firm focused on franchising
Darrell M Johnson is the president and CEO of FranData, an Arlington, Virginia information services company for the franchising industry
dkoch@plavekoch.com
djohnson@frandata.com