20 Franchising

When you have set up a business successfully in one location, the race is on to do the same elsewhere. If you do not 'copy' your idea, others will. Yet how can a small business quickly clone its own idea, many times over? It is hard to start up one business outlet, let alone lots of them.

One answer to this problem is **franchising**. This means selling the rights to use a business idea and methods in a specific location or area. The person or business buying the rights therefore has to do all the work to make it a success. The franchise owner must ensure they select someone who will do a good job – and therefore not damage the image of their business.

There is no better example of this than the Subway chain of sandwich shops. It was started in 1965 in America by 17-year-old Fred deLuca who borrowed $1000 and set up a single outlet. Its success led him to open others, but he saw much bigger prospects, so started selling franchises in 1974. By 2016 there were 45,000 Subway outlets worldwide. The first Subway store came to the UK in 1996 and there are now more than 2,000. The chain is the UK's biggest seller of sandwiches, pushing Tesco into the number two position. In fact, in 2015 and 2016 Subway sales in the USA struggled due to increasing competition, but in the UK they still seem to be growing.

What's in it for the franchise owner?

Expanding a business is expensive and can be difficult. Opening stores requires a large amount of capital. For example, a Burger King store typically costs £500,000. Selling franchises brings money in, instead of paying money out, and eliminates the need to employ huge numbers of managers to check up on every aspect of the store openings. The main benefits of expanding by selling franchises include:

- A firm can expand its sales quickly; this helps fill gaps that other businesses will fill if the firm does not get there first.
- Franchise owners not only sell a franchise, but also receive a share of all future sales. Subway (the franchise owner) receives 8 per cent of the sales revenue of all 45,000 stores; in addition, every store must buy their supplies from Subway, so the central company makes profits there too.
- The franchise owner can concentrate on developing new products and services, and on good marketing and advertising; this was the basis of McDonald's' huge success for many years.

Talking point

What might the advantages and disadvantages be for Tesco if they franchised out their Tesco Express (local) stores?

Starting up a franchise operation

Starting a business from scratch requires a wide range of skills. Anyone can have a bright idea; and many people are good at one particular thing – cooking, for example. Yet simply being a good cook is not enough to run a successful restaurant. You need to:

- identify a menu and an image that customers want
- work out how to run the operation efficiently
- find suitable suppliers
- market the business effectively.

It is not surprising that half of all new restaurants close within three years.

A franchise start-up takes on the brand, products and methods used by other outlets

Benefits of franchising

The key benefits of franchising (buying into a franchise) include:

- The franchise operation not only buys its part of an image (for example, McDonald's or BSM – the British School of Motoring), but also a method for doing things (for example, the equipment for making a milkshake, plus the instructions on how to make it, clean the equipment, and so on).
- An individual outlet could never afford image-building TV advertising; being part of Subway or McDonald's, for example, enables the franchise operation to benefit from major marketing campaigns.
- As the products and methods of working have been pre-tested, the chance of mistakes is lower; therefore the failure rate of franchise start-ups is also lower. This means that banks are much more willing to lend to a franchise start-up than a brand new, independent operation.

> There are a lot of cowboys about.
>
> *Sir Bernard Ingham, former president of the British Franchise Association*

Being part of a franchise may enable you to benefit from major marketing campaigns

Drawbacks of franchising

Franchising is a halfway house towards running your own independent business. When buying into a franchise the buyer is bound by the rules of the franchise owner. This might be very frustrating for an experienced businessperson who wants to be their own boss. The rules may force them to offer products that sell well nationally, but not locally. Among the other possible drawbacks are:

- Royalty payments (fees to the franchise owner) of as much as 8 per cent of revenue are common. A typical franchise outlet might have an annual sales figure of about £300,000, so an annual

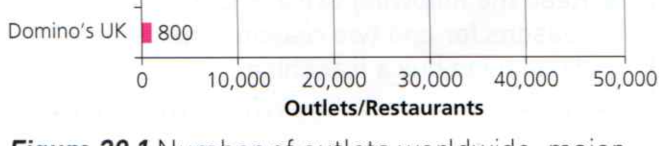

Figure 20.1 Number of outlets worldwide: major catering franchises 2016 (Sources: company websites and press releases)

payment of £24,000 is being made. That is no problem when things are going well, but in 2015 and 2016 sales at US Subway outlets fell by 10 per cent. It would be very annoying to pay large **royalties** when sales and profits are falling.

- Not all franchises are good ones. In September 2014, six *G-Star* franchise stores were closed, with high rents thought to be the direct cause. Fashion trade magazine *Drapers* was told: 'There just isn't enough of a margin in a franchise store to keep up with the massive rents they are being charged.'

Talking point

If you decided to start a business, would you prefer to be independent or buy into a franchise?

Drawing the right conclusions

As with any other business opportunity, buying a franchise carries major risks. The buyer needs to check the financial records of the franchise owner and talk to existing franchisees to find out whether they are happy with the service they are getting for their royalty payments. Without doubt, though, buying a good franchise is one of the best ways to start your own business. Having built up business experience running a franchise, an **entrepreneur** could try to start up a completely independent business later on.

Revision essentials

Franchising paying a franchise owner for the right to use an established business name, branding and business methods.

Royalties percentage of the sales revenue to be paid to the overall franchise owner.

Entrepreneur a person who sets up a business and takes on financial risks in the hope of profit.

End of chapter exercises

1 Give two reasons why it is hard to develop a business rapidly.

2 Look at Figure 20.1 on page 97. Domino's UK is growing rapidly, but from a low base. By how many times must it increase its number of outlets to catch up with Subway?

3 Explain one advantage and one disadvantage of running a local Subway franchise compared with running an independent sandwich shop.

4 Explain why a bank might be more willing to lend money to someone opening a franchise outlet than someone opening a fully independent business.

5 Read the following extract. Outline two reasons for and two reasons against Ian deciding to buy a franchise.

Ian Jones had spent ten frustrating years as a journalist, working on a shipping magazine. He had been saving for several years to start his own business. He had £45,000 in the bank and a burning desire to prove to his wife and parents that he could be a financial success. Ian loved eating out, and wanted to start a bar/restaurant. Now he had to decide whether or not to buy into a franchise operation such as Domino's, or start something completely independently. He knew that, if necessary, he could borrow up to £100,000 on the value of the house he owned jointly with his wife.

6 Recommend whether he should buy a franchise or go independent. Explain your answer.