



SWP 10/88 FRANCHISING IN THE UK

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FRANCHISING

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FRANCHISING

The term franchise covers a wide variety of arrangements under which the owner of a product, a process, a service or even just a name having certain connotations (e.g. that of a sportsman) licenses another to make or use something in exchange for some form of payment. This can be either direct, in the form of a fee and/or a royalty, or indirect in the shape of an obligation to buy a service or product in which the licence holder has some kind of commercial interest. In the United Kingdom the "tied" pub, which has been around for over 150 years, is one example of this type of arrangement.

In the USA franchising is reputed to have started with Singer Sewing Machines after the American Civil War, when the Continent emerged as a vast market, but when communications were too poor across great distances to make centralised distribution effective.

The concept was picked up by the motor car industry, though their problem was more one of establishing outlets to provide display space, back-up service and, of course, to buy the cars. All the manufacturers money was tied up in plant so they could not finance stock too.

The success of such forms of franchise encouraged numerous imitators from the twenties to the fifties, during which time

the trend was to rationalise small, locally-based manufacture into national and even multi-national entities. This did, however, cause problems of sales and distribution. Local industries, aware of local market conditions, were shown in many cases to have been rather more successful in this respect than 'faceless corporations' located a long way distant. The answer was to re-create, in some way, the virtues of local industry by franchised distribution and licences. From the point of view of the franchisor, these arrangements turned out to have other advantages as well over the costly alternative of keeping total control by setting up national networks of salesmen and warehouses to cover a region - and in the post-war period, overseas countries. The franchisee was usually more dedicated to the interests of the franchisor, in whose success he stood to share, than many a salaried employee would have been. This was true even when the franchisee was also trading in goods and services other than those for which he held a franchise - indeed distributorship franchises were often arrangements which placed no great obligation on the franchisor and gave a corresponding amount of freedom to the franchisee.

There are five types of relationship between Licensee and Licensor which can be described as franchises.

A distributorship for a particular product, such as a make of car or whitegoods such as washing machines, cookers and

refrigerators. A distributorship is sometimes confused with an "agency", which is a quite different legal relationship. An agent, even though he is not employed by him, acts on behalf of a principal. What that agent does, says, or represents to third parties is as binding on the principal as if they were employer and employee. A distributorship, however, is an arrangement where both parties are legally independent, as vendor and purchaser, except that the purchaser, in exchange for certain exclusive territorial rights, backed up by the vendor's advertising, promotion and, possibly, training of his staff, will be expected to hold adequate stock and maintain his premises in a way that reflects well on the vendor's product or service.

A licence to manufacture a certain product within a certain territory and over a given period of time, have access to any secret process this involves and use its brand name in exchange for a royalty on sales.

This arrangement resembles a distributorship. Licensor and licensee are independent of each other, except that the licensor will no doubt insist that the licensee complies with certain specifications as regards content and quality in order to preserve the good name of his product. This arrangement is often found in industry and two well-known recent examples have been the Rank Organization's licence to produce the photocopying devices pioneered by the Xerox Corporation and the licences granted by Pilkington's for their revolutionary plate glass manufacturing process.

The use of a celebrity name to enhance the sales appeal of a product and guarantee, at least by implication, its quality.

The most common example is the endorsement, by a sports personality, of equipment associated with his activity and bearing his name, in return for a royalty payment by the manufacturer. Examples of this include Arnold Palmer golf clubs and Steve Davis snooker sets. (So lucrative can this activity be, that a company, MATCHROOM, has been floated on the Unlisted Securities Market, whose main asset is the rights to four snooker players names).

The use of a trade mark. Here a widely recognised product is exploited commercially for a fee and subject to certain licensing conditions, rather than the name of an individual. A recent instance is the advertising of various micro-computers as being IBM compatible, always shown with the symbol TM beside it. Yet another example of licensing a trademark is that of the ubiquitous use of the Dolby system in most cassette tape recordings.

Business Format franchising. Although all these forms of franchising continue to flourish, Business Format franchising has emerged as the dominant and the most rapidly expanding mode. Business format franchising incorporates elements from all these earlier ideas and combines them in a way that is particularly suited to current circumstances and economic conditions. Its main features are:-

1. It is a licence for a specific period of time to trade in a defined geographic area under the franchisor's name and to use any associated trade mark or logo.
2. What is franchised is an activity, usually some form of service, which has already been tried and tested to produce a formula of operating that has been found to work elsewhere.
3. The franchisor provides the entire business concept of that formula (usually called the 'blueprint') for the conduct of operations. This must be followed by the franchisee. In fast food, for instance, the ingredients of any 'secret' recipes for the type of food being offered are strictly laid down, as are the specifications for the surroundings in which it is served.

The blueprint is generally set out in an operating manual which is given to the franchisee when negotiations are completed.
4. The franchisor educates the franchisee in how to conduct the business according to the method laid down in the blueprint.
5. The franchisor also provides back-up services in order to ensure that the franchise operates successfully. This should certainly cover advertising and promotion of the franchise's name in general and may also cover

promotion of the particular franchise in its locality. It can cover many other aspects: ongoing business advice including help in raising finance, market research into the viability of a particular location for trading purposes, assistance with negotiating leases and obtaining planning permissions, site development, the provision of building plans and specifications, a standard accounting system - virtually anything connected with setting up a new business.

6. In exchange for the business blueprint and the services the franchisor provides, the franchisee is expected to make an initial investment in the business and to pay a royalty to the franchisor thereafter, based on turnover or profits. There may also be an obligation on the franchisee to buy some or all goods and equipment from sources nominated by the franchisor.
7. The participation of the franchisor in setting up the business does not mean that he owns it. It belongs to the franchisee and he is free to dispose of it, though he will probably have to give the franchisor first refusal and obtain his approval of the person the business is sold to, if the franchisor does not want to take it off his hands.

Pyramid Selling is often confused with franchising in the mind of the uninitiated. A mistake that has done much to harm the reputation of franchising in general and business format franchising in particular. That both pyramid selling and franchising operations have been in the hands of unscrupulous owners whose main objective has been to defraud the "franchisees", is not in dispute. But there the similarity ends.

Pyramid selling is a form of multi-level distributorship which typically involves the manufacture or sale by a company, under its own trade name, of a line or products through "franchises" which appear to be regular franchise distributorships. The pyramid may include three to five levels of non-exclusive distributorships, and individuals may become "franchisees" at any level of entry. Once in, the individual earns a commission by selling the company's products, but at higher levels in the pyramid it is made more attractive to introduce new members.

This product is sold down the chain at progressively higher prices, until the final person has to sell to the public. Since most people make a profit by merely being a link in the chain, the emphasis is placed on recruiting more investor/distributors, rather than on selling to end customers.

The schemes, like chain letters, are lucrative for those at the top of the pyramid. But inevitably the market becomes saturated, and no further participants can be recruited - the

system then collapses.

Contrary to public opinion, Pyramid Selling is not illegal in the UK. It is however controlled by the Fair Trading Act 1973 (Section 118) and the provisions of the Consumer Credit Act 1974. It is, however, expressly excluded in the American Franchise Association's Code of Ethics.

THE GROWTH OF FRANCHISING

The United States is the world's largest Business Format franchising market. In 1984 sales by the 1,700+ franchisors exceeded \$120 Billion, compared with \$100 Billion in 1982 and \$90 Billion in 1981. Over 300,000 establishments existed compared with 260,000 in 1981.

Large franchisors, those with 1,000+ units dominate the Business Format market, with 57 companies accounting for 55% of all outlets.

Although viewed as a safe way into business a total of 60 franchisors operating 2,000 outlets failed in 1982. Their turnover of \$244 million represented only a fraction of a percent of all Business Format sales.

There is also evidence that franchisees were in general satisfied with their investment. Of the 11,515 franchise arrangements that came up for renewal 89% were renewed and 1,237 were not. Of those 245 were not renewed because of objections by the

franchisor, 737 because the franchisee did not wish to renew, and 255 by mutual agreement.

The UK also has a large and growing business format franchising industry. In 1985 some 220 franchisors operated over 8,000 outlets, generating sales in excess of £1 Billion, and employing over 70,000 people.

Three major markets account for two-thirds of all UK franchises: home improvements and maintenance companies represent 31%; food and drink, 18%; and business services, 17%. The split by turnover reveals a somewhat different picture. Food and drink accounts for 29%, business services 21% and home improvements 10%.

In terms of concentration 5% of franchises account for 35% of total franchise units and over 50% of sales value.

Franchised outlets have trebled since 1980 and the growth in sales turnover has consistently out-performed the growth in both retail sales and consumer expenditure. By 1990 the forecasters make this market worth as much as £5 Billion or as 'little' as £2 Billion.

FRANCHISING - GROWTH AND FORECAST

Year	Turnover (£M)	% Annual change	Retail sales (£M)	% Annual change	Consumer Exp. (£M)	% Annual change
1980	390	-	57 400	-	137,300	-
1981	450	15.4	62,100	8.2	153,100	11.5
1982	515	14.4	67,100	8.0	168,400	10.0
1983	600	16.5	73,300	9.2	184,500	9.5
1984	750	25.0	79,200	8.0	201,000	9.0
1985 (EST.)	1,000	33.3	85,900	8.5	218,200	8.5
1990	2,000-5,000					

The growing maturity of franchising in the UK was signalled by the Body Shops successful float on the USM, on 16 April 1984.

The international growth league for franchising is headed by the USA closely followed by Canada and Japan. In Europe, the United Kingdom is in close company with France, Belgium and Sweden in the rate of development of franchise networks. France is second to the USA in the rate of penetration of the UK market by overseas franchisors

Other areas with a significant level of franchise activity include: The Caribbean; Asia (other than Japan); Australia; Mexico; South American; and the Middle East.

THE FRANCHISORS

From the franchisor's point of view, the advantages to forming a franchise chain are that he does not have any direct investment¹ in an outlet bearing his name (though if he does his job properly, there are indirect costs in training the franchisee and providing adequate promotional and other back-up to ensure the success of the franchise); that the franchisee, as the owner of the business, is more likely to be highly motivated than an employee and more responsive to local market needs and conditions; that he saved on personnel and administrative costs; and that, without direct financial involvement, he may in this way derive some of the benefits of expansion, inasmuch as franchising gives him economies of scale from centralised purchasing and, if he wishes it and it is feasible, some degree of centralised administrative facilities.

The disadvantages are that although the failure of an individual franchise may reflect badly on the franchise operation as a whole, all he can control is the format itself and he can only influence the running of individual operations by pulling the reins on this or that clause in the agreement - the broad terms of which we shall discuss shortly. In extreme cases he may terminate the agreement or at any rate not renew it, but he cannot throw the franchisee out as if he were an employee. He is therefore dependent on the willingness of the franchisee to observe the rules and play the game, while at the same time any failure to do so is equally and perhaps more damaging to

Footnote:

¹ Some Franchisors, such as Apollo Blinds, own the premises from which the franchisees operate, who in turn pay rent. In such cases the Franchisor's investment is more akin to a portfolio of properties, rather than a direct investment in the franchisee's business.

the franchisor (and to other franchisees) than to the franchisee concerned because of its adverse effects on the franchise as a whole.

Another disadvantage sometimes turns out to lie in the curious mixture of dependence and independence that franchising produces. The franchisee is encouraged to think of himself as an independent business entity and to a large extent this is indeed the situation. Nevertheless he is operating the franchisor's business concept under a licence for which a fee is payable. There are cases where the franchisee identifies so closely with the particular business he is running that he ultimately resents the payment of the fee. The success is felt to be due to the franchisee's efforts, not to the franchise concept or to the franchisor. This is apt to be particularly so if the franchisor adopts a lower profile than he should, either in terms of direct help or in matters such as national advertising. Clearly, of course, the franchisee would be obliged to pay under the terms of the agreement, but a sour relationship is not good for either party, so it is up to the franchisor to maintain his part of the bargain both in letter and in spirit. Franchises are a matter of mutual interest and obligation.

Successful Franchisors

Unlike many other forms of new enterprise, franchising is predominantly full of success stories. Kentucky Fried Chicken (KFC), begun in 1952 by Colonel Hartland Sanders has grown into

one of the largest fast food franchise chains, world wide. McDonald's started three years later has overhauled KFC with around 7,000 outlets and a presence in most overseas markets. Holiday Inns and McDonalds are both large enough to support their own "Universities" to train and develop their prospective franchisees.

In the UK, Anita and Gordon Roddick have taken their Body Shop venture from a leaky shop in Brighton to public company with an annual turnover of nearly £10 millions in just eight years.

Like all good ideas, the initial concept was so simple that you now wonder why nobody had previously thought of it. Anita Roddick looked at cosmetic products, and realised that a large part of their costs were incurred in producing expensive disposable wrapping and containers. In addition, the products themselves were almost entirely man-made and synthetic, at a time when beautyconscious women were becoming aware of the animal experimentation lobby and of the move back to nature in foods and health products. Producing natural products in cheap refillable containers made both commercial and ecological sense.

The idea for the name came during a visit to the USA where the Roddick's saw a car repair place called the Bodyshop.

Using a recipe for honeyed beeswax and almond oil from Pliny and £4,000 borrowed from Barclay's bank in Littlehampton, the Body Shop was launched.

The formula was an instant success. From the original store in Brighton, the total number of outlets mushroomed to a nationwide chain of 43 shops at the time of the placing, with a further 56 shops overseas in 16 countries. In the five years from 1979, profits grew ten-fold.

BODY SHOP			
	No. of outlets		Profits
	Home	Overseas	(£000)
1981	22	17	31
1982	32	30	114
1983	43	56	275
1984 *	49	83	1,043
1985	72	120	1,929
* USM flotation April 1984			

By 1984, Body Shop was ready for a public listing. The Company's shares, priced at 95p in the April 1984 placing, currently¹ trade at well above the 800p mark, having briefly touched 850p. In its first full year on the market, it reported an 86 per cent profit rise to just under £2m on turnover of £9.4m - an exceptional margin for the stores sector.

Footnote:

¹ At January 1986.

In 1986 the Body Shop announced plans for a full Stock Exchange² listing and there was a two year waiting list for the "privilege" of becoming a Body Shop franchisee. Apart from patience prospective franchisees also need £30,000 to invest in the venture.

An equally impressive performance has been turned in by Pronto-print, the Northern based fast print chain launched in 1971, using a franchising formula that had been tried and tested by others in the USA.

With 300 franchised outlets and a market capitalisation on the USM of £12 million, it is one of the largest UK franchisors.

It would be quite wrong to imply that franchisors all succeed. On average, 60 franchisors a year fail in the USA, and a dozen or so have failed in the UK over the past couple of years. The two largest UK failures, Zeibart and the Pronuptua, Young's and La Mama Chain, involved well over 100 franchisees, who for the main part were able to continue trading under new owners or as independent operators.

Footnote:

¹ Only ten companies graduated from the USM to a full listing in 1985.

Developing the Franchise Chain

The central economic benefit of franchising to the franchisor is the ability to expand rapidly, first cultivating and then dominating a chosen market segment, moving at a speed that a conventional firm would find nearly impossible to fund or to manage successfully. This combination of high market share and fast growth can be expected to deliver a good return on investment and a secure, even unassailable market position.¹ All this depends on the franchisor's ability to develop a successful franchise chain, which in turn depends on getting a number of things right - consistently.

The Blueprint must work. What the franchisor should be selling is a proven business concept that is capable of being replicated. This requires that the franchisor should set up a pilot unit, from which an operating manual to run future units can be devised and tested. The operating manual must set out how every aspect of the business should be run, from "making" the product, through accounting and control systems to recruiting and appraising staff, and advertising and promotion. Ideally this business format as set out in the operating manual should

Footnote:

¹ Profit Impact of Market Strategies (PIMS)

A major research programme initiated in 1972 at the Marketing Science Institute at Cambridge, Mass., and now run by the Strategic Planning Institute, an independent non-profit making organisation.

The aim of the programme is to provide businessmen with information on what factors had the greatest impact on profitability under various competitive conditions. In effect to uncover the "laws of the market place". The study embraces 57 corporations with 62 separate businesses. Profit performance was found to be related to

and develop

then be further tested on a small number of franchisees to confirm that the "formula" developed in-house is transferrable.

Only now can the franchisor turn his attention to expanding his franchising chain. It is not surprising that the greatest number of failed franchisors omitted much of this key stage, either because of poor management within their own firm, or a wholly inadequate capital structure.

Recruiting and Training Franchisees. Franchising is nothing if not a people business. Finding potentially successful franchisees goes way beyond just identifying people with the requisite amount of capital, and who are prepared to part with their money with the minimum of fuss. This has certainly been the practice of "cowboy" operators however the European code of ethics on recruitment set out below provide for a sounder approach.

European Code of Ethics on
Recruiting and Selecting Franchisees

Rules Governing Recruitment Advertising

Recruitment advertising will be honest and genuine. It will not contain any ambiguity and should not be misleading in any way. All advertising will comply, both in form and in spirit, with the laws and regulations.

Any recruitment advertising which contains direct or indirect allusions to results, figures or data relating to the income or profits which can be anticipated by franchised firms, will be

objective, complete and verifiable, especially with regard to the geographic area and the period to which it relates.

Any information relating to the financial aspects of the acquisition of the franchise will be detailed in all respects and will indicate the total amount of investment required.

Selection of Franchise Holders

The Franchisor will select and accept only those franchise candidates who possess the qualifications required by the franchise. All discrimination on the grounds of politics, race, language, religion or sex, will be excluded from the qualifications.

Once recruited, the franchisee must be rigorously trained in every aspect of how the "blue print" works. McDonald's, for example, insist on a minimum of 200 hours training before they will take on a franchisee. Once accepted they undergo a further 11 days of basic operations training and two weeks management training at Hamburger University of Elk Grove, Illinois.

Territory Size and Site Location. In defining catchment areas, territories and locations it is vital to make sure that the franchisee has a market of sufficient size for him to prosper and expand, but not so generous that he cannot properly service it. This will involve the franchisor in some basic market research covering such aspects as, traffic flows, access,

and so forth. In franchises

that require a retail site, soundly based and proven criteria for locating those sites is essential. More scrupulous franchisors frequently keep prospective franchisees waiting for up to two years until the right site comes onto the market.

Controlling and Motivating Franchisees. To some extent franchisees can be considered to be self-motivation, after all they own the business. But however careful the selection process, problems are bound to arise and in any event the franchisor will want an efficient system of communicating details of new or improved products and processes. This means that the franchisor must maintain a controlling head office function with some support staff, trouble-shooters and a franchise management team. Their role must include that of making sure that blueprint is being followed throughout the chain, and that it is being continuously updated in the light of experience.

Any failure to support the existing franchise chain are likely to result in a disgruntled and highly vocal group of franchisees making future recruitment difficult. In the USA a National Franchise Association was formed in 1975 to provide a centre for the expression of the franchisee's viewpoints. No such organisation currently exists in the UK, but the bush telegraph works well within individual franchise chains.

Creating a good secondhand market. As the franchise chain develops it is inevitable that some franchisees will want to sell up and move on. The franchisor will normally insist on first refusal - or at the very least the right to approve the prospective purchasers. This process requires careful and sensitive handling as every impediment to a smooth sale has the probable effect of reducing the value of the franchisee's equity in the venture. In much the same manner, the market for new cars is dependent on a vigorous market for used cars that can be seen to hold their value.

The mixed ownership chain. Occasionally, an established business, having made the decision to grow via the franchising route, will sell off some, or all of their existing outlets. A recent example is Holland and Barrett. By 1984 they had 150 company-owned outlets but their market research indicated the UK could support around 2,000 health food shops by 1990. To maintain their 20% share of this market they would need a further 300 or so outlets. With three manufacturing subsidiaries to finance in this rapidly expanding market, Holland and Barrett opted for franchising as a way forward in the retail market. As a consequence a number of 'quality' outlets were put onto the market.

This situation can be viewed as a particularly good example of proving the blueprint.

Financing the Franchisor

Business format franchising calls for a substantial investment of both capital and management time before the chain can be developed. Unethical franchisors have used franchisees' money to finance pilot operations, product and process proving and even the writing of the very operating manual that they are supposed to be selling as the formula for success.

Established business ventures such as Holland and Barrett have access to the normal sources of development capital that are open to any growing business. But until 1985 there was no specific source of finance for prospective franchisors, when Franchise Investors Ltd. (FIL) was launched by Granville and Co., the corporate finance group, to provide finance and expertise for franchisors. Its initial capital of £1.25 million is to help companies that want to expand by franchising. FIL's backers include Causeway Development Capital, Post Tel Investment Management and Legal and General, which together own about 75% of the Equity. The rest is held by Granville and Co. and the founders. It plans to identify and take equity stakes in companies whose business is suitable for franchising. It also intends to buy master licenses, probably from North American companies, and develop franchise networks in the UK. With this exception the City has virtually ignored the franchise market, with the exception of the clearing banks who provide a ready source of funding for franchisees. Even the Body Shop's floatation on the USM only raised £100,000 for the company itself.

THE FRANCHISEES

From the point of view of the franchisee there are advantages and disadvantages which might perhaps be most clearly expressed in the form of a list.

Advantages

- * A business format or product which has already been market tested and, presumably, been found to work; consequently, major problems can be avoided in the start-up period.
- * A recognised name of which the public is already aware and which has credibility with suppliers.
- * Publicity, both direct in that the franchisor advertises his product or services, and indirect promotion through signage and other corporate image promotion in all the franchisor's outlets.
- * Usually a smaller initial capital outlay than if the franchisee was starting up on his own - though franchises which have shown a very high profit record are correspondingly expensive and can run well into six figures.
- * Direct and close assistance during the start-up period.
- * A period of training on production and management aspects.
- * A set of standard management, accounting, sales and stock control procedures incorporated in an operating manual.
- * Better terms for centralised bulk purchase negotiated through the franchisor, though he may be looking to mark-ups in this area as a source of revenue from the franchisee.

- * Design of the premises to an established scheme saves on interior design fees and may eliminate these altogether where the franchisor has a set of specifications.
- * The benefit of the franchisor's advice on equipment and initial inventory levels, though this may not be impartial where the franchisor is also the supplier.
- * Help with site selection, negotiating with planning officers and developers.
- * Possibly, though not universally, access to the franchisors' legal and financial advisers.
- * The exclusive rights to the franchise within a given area.

Disadvantages

- * Business format franchising is, of necessity, something of a cloning exercise. There is virtually no scope for individual initiative in matters of product, service or design. However, the franchisor will demand uniformly high standards of maintenance, appearance and packaging in whatever the franchise entails. These are usually monitored by regular inspections.
- * The fee paid to the franchisor. This may be a percentage on gross turnover or on profits. The problem here is that if the franchisor is not pulling his weight or if the franchisee does not feel this to be the case, the fee can be a subject of bitter dispute. The franchisee may then feel justified in withholding all or part of it on the grounds of non-performance by the franchisor, but this is always a difficult matter to prove in the courts. Furthermore

the franchisor's resources to conduct a long drawn-out case will usually be greater than the franchisee's.

- * A further problem is that a high turnover does not necessarily imply a highly profitable operation. If the franchisor's fees are wholly or partially based on turnover, he may try to push for this at the expense of profitability.
- * The franchisee is not absolutely at liberty to sell the franchise even though he is in many respects operating the business independently. The sale has to be approved by the franchisor, who is also entitled to vet the vendor and charge the cost of any investigations made to the existing franchisee. Furthermore, although the business would be valued as a going concern in trading terms, the goodwill remains the property of the franchisor. Again, the franchisee may feel that, at least to some extent, the goodwill has been built up by his own efforts. The resale of a franchise, in other words, is a process rich in those grey areas which can lead to expensive litigation.
- * Exclusive territory agreements may be difficult to enforce in practice. For one thing, under EEC competition laws the franchisor cannot prevent one franchisee trading in another's 'exclusive' territory, though he may decline to licence a competitor within it.
- * The franchisee, as well as paying a fee to the franchisor, may be obliged to buy goods and services from him as well - possibly at disadvantageous rates.

- * Though the franchisor places all sorts of controls and obligations on the franchisee to maintain the quality of his image, the scope for doing the reverse is more limited. If the franchisor's product or service gets bad publicity, this is bound to affect the franchisee adversely, and there is very little he can do about it. Equally, the franchisor may engage in promotional activities - and involve the franchisee in them as well - which, though perfectly harmless are, from the point of view of a particular outlet, an irrelevant waste of time.

Mutual Dependence

From this list of advantages and disadvantages to both parties a more detailed picture emerges of the business format franchise as a relationship of mutual dependence which allows each party to release his strength to mutual and, at best, equal advantage. The franchisor is able to expand without further investment and, though the return is obviously lower than from expansion by ownership, he does receive an income from the franchisee as well as getting both an outlet for his product and more muscle in negotiating the purchase of materials and equipment. The franchisee, on the other hand, is able to concentrate his entrepreneurial skills at the sharp end of sales and customer service, while the administrative headaches of setting up the business are mitigated by the uniform nature of the format. By the same token he is saved, through feedback to the franchisor of the accumulated experience of other franchisees, from making the errors to which businesses are

prone in their earlier and most vulnerable stages. This relationship is expressed in agreements: the purchase agreement and the franchise agreement. It naturally follows that a prospective franchisee must satisfy himself that the franchise on offer is a sound investment. Close questioning of both the franchisor and existing franchisees along the lines of the points raised in this section will help with this appreciation.

POPULAR FRANCHISES

Franchise operations fall into three main groups. The simplest form and usually the cheapest to acquire is a service which is run from home, an interior design consultancy, for instance. Much the largest group of franchises, though, are those which entail acquiring premises and often a substantial investment in equipment in addition to the initial fee payable to the franchisor: fast food restaurants and print shops are two of the most visible and widespread franchises of this type. At the top end of the market are investment franchises like Holiday Inn, where the start-up costs run into six figures. There are also some franchises which overlap the second and third categories: a prime Wimpy bar franchise will now also run into six figures. Overall the range of activities which can be franchised is very wide and some 65 have been identified in the USA, going from hotel ownership at the top end to a soft drink bottling franchise with the unlikely name of Cock 'n Bull at the other. There are at the moment at least 20 types of franchise in Britain, covering a variety of fields from fast food to acupuncture.

In the UK, for which statistics are still hard to come by, the largest number of franchisees are in the motor vehicles and associated services, food, hotels and restaurants and the business and personal services sectors.

Franchising Trends in the UK 1983-84 (Number of Outlets)

	<u>1983</u>	<u>1984</u>	<u>% Growth</u>
Beauty and Health	47	62	32
Building & Maintenance	175	244	39
Food, hotels and restaurants	816	949	16
Motor vehicle and associated services	879	999	14
Printing	336	422	26
General Retailers	251	325	29
Business and Personal Services	<u>638</u>	<u>763</u>	<u>20</u>
TOTAL:	<u>3,142</u>	<u>3,764</u>	<u>20%</u>

(This table has been prepared from survey data provided by about half of all UK franchisors).

In the USA, much more detailed information on franchise activity by business category is available. Here restaurants are the most popular, followed by auto-products and services, followed by business aids and services. A number of categories such as recreation, entertainment and travel; real estate; employment services; accounting, credit collection and tax preparation; and educational services, are barely visible in

Franchising Trends in the US Economy 1981-83 (Number of outlets)

	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>% Growth over Period</u>
Restaurants	61,846	65,151	70,500	14
Convenience Stores	15,524	16,256	17,231	11
Food Retailing	16,171	17,106	18,429	14
Auto Products and Services	39,616	39,721	41,496	5
Hotels, Motels and Campgrounds	6,416	6,622	7,350	15
Recreation, Entertain- ment and Travel	5,293	5,625	6,000	13
Business Aids & Services	48,835	49,672	58,608	21
Employment Services	4,719	4,772	5,299	
Printing and Copying	2,839	3,808	4,352	
Real Estate	15,636	16,165	17,698	
Accounting, Credit, Collection, Tax Preparation, etc.	22,641	24,927	28,259	
Car and Truck Rental	7,463	7,863	8,284	11
Equipment Rentals	1,635	1,683	1,776	9
Construction, home improvement and cleaning services	14,732	15,600	17,400	18
Laundry and Dry Cleaning Services	3,105	3,178	3,273	5
Educational Services	3,914	4,381	5,022	28
Beauty Salons	1,650	1,769	1,984	20

* From figures published by US Department of Commerce.

FINANCING THE FRANCHISEE

In the USA, the full gamut of venture capital sources is open to franchisee and franchisor alike. This includes assistance from the Small Business Administration (SBA), founded in 1953 for the purpose of providing intermediate to long term financing for small businesses which could not obtain money on reasonable terms from elsewhere.

In the UK, on the other hand, the City institutions have largely shunned involvement with the franchise industry. Government small business financing schemes such as the Loan Guarantee Scheme¹ and the Business Expansion² scheme have at best played an insignificant role in financing franchising, and at worst appear to have been designed to specifically exclude them.

The exception has been the main clearing banks. Five of them, Barclays, The National Westminster, Lloyds, The Midland and The Royal Bank of Scotland, have identified franchising as an important market for them to be in. As well as earmarking some tens of millions of pounds to lend to franchisees, they have appointed managers and special departments who can offer both general and specific advice to help potential franchisees to evaluate a franchise.

Footnotes

¹ Introduced in the UK in 1981, to allow the clearing banks to lend up to £75,000 over 2-7 years to small businesses that do not meet normal lending criteria. The government guarantees 70% of the funds on loan.

² Introduced in the UK in 1983, to make it attractive for higher rate tax payers to invest in certain categories of new or growing businesses. Each investor can get tax relief at their highest rate on up to £40,000 invested in any one year.

The banks have found the market particularly attractive for two reasons. Firstly, lending to franchisees is easier and less time-consuming than lending to individual small businesses. They only have to evaluate a specific franchising concept in detail once, to allow them to agree in principle to lend to dozens of franchisees; and the franchisor selects suitable candidates only, to put forward to the bank for financing. Secondly, much of the start-up finance required is to buy, lease or improve premises¹. This meets the security criteria that is always high on the clearing bankers shopping list, when viewing a lending proposition.

The banks have one more weapon in their protective armory. Normally a borrower's relationship with his bank is his business alone. However, banks have been known to ask franchisees to sign a release when they advance a funding package. This allows the bank to tell the franchisor if they are exceeding their financial limit.

Nevertheless this ready supply of funds from the banks has done much to encourage and facilitate the growth of franchising in the UK.

Footnote

1

Newly-appointed franchisees have to find an average of £26,000 - just under £5,000 for the franchise fee and £21,000 for premises, equipment and fittings. Recurring annual payments to the franchisor total nearly £9,000, two-thirds of this being a 5½% royalty on turnover, and two-thirds of the balance being a 4½% mark-up on supplies.

DEVELOPING THE BUSINESS

Once the potential franchisor has decided that franchising is right for him, has chosen a franchise, and found the money to finance, what options then lie ahead to develop the business, apart that is, from doing the present job better ?

Extending the product or service range. The franchisee is usually in the hands of the franchisor in this respect. It is unlikely that the average pizza house franchisee would be encouraged to start up a new line in English cooked breakfasts, for example. Corporate identity is a great strength for a small firm, but it also inhibits flexibility, initiative and enterprise. When it comes to introducing new products, the initiative comes from the franchisor, and the chain is expected to march forward together.

In recent years Kentucky Fried Chicken have added Apple Pie to their menu, and McDonalds have added fish, a breakfast menu and chicken, to their traditional range of hamburgers.

Horizontal Growth. Many franchisees take on neighbouring territories, once they have satisfied themselves that the business format works. Both the Body Shop and Servicemaster have several franchisees with between 2 and 4 shops/outlets each. This has the obvious benefit that the franchisee fully understands the business, but it can pose some problems with geography. Certain franchises, by the definition of the catchment area needed to support them, have to be many miles

The Town Ownership Concept. Not much in evidence in the UK, but popular in some parts of the USA. The concept requires a successful franchisee to take on several different types of franchise in the same town. For example he could own franchises in fast food, car hire, office cleaning and a beauty salon. This would involve selling more products to much the same people. This approach reverses the benefits and problems of horizontal growth.

Trading Up. This is a variation of the horizontal growth approach, in which a franchisee sells out a small outlet and trades up to a larger one that hopefully will generate more profit. Both Wimpy and Kentucky Fried Chicken have two main sizes of franchise outlets that lend themselves to this strategy.

FUTURE DEVELOPMENTS

In the USA the main growth in business format franchising is expected to come from the following activities, financial counselling services; home repair; insurance; legal service centres; accounting service centres; medical services; dental clinics and business brokers. Also high on the list are: weight reduction centres; figure control centres; smoking control centres; exercise studios; computers (hardware, software and counselling) and safe deposit locations. With maturing home markets American franchisors are looking for International Market Opportunities in increasing numbers. At present some 300 franchising companies are operating around 22,000

outlets abroad. The table below shows the main geographic split of that activity:

US Franchisors Operating Overseas

<u>Country of Region</u>	<u>No. of Franchisors</u>	<u>No. of Units</u>
Canada	209	7,068
Japan	63	3,999
Continental Europe	75	3,393
United Kingdom	52	2,113

Last year a further 121 American Franchisors indicated that they were looking for opportunities to set up overseas. The interest was expressed mostly by small and medium sized franchisors, and "business aids" was the largest market sector to be pioneered.

This expansion of American franchisors outside the boundaries of North America will continue. In a mature franchise market such as the USA, exporting is one important way forward.

A look at what is going on currently in the USA reveals some interesting and sizeable gaps in the UK franchise market. (Compare the preceding tables on the USA for yourself). In the USA the new franchise areas are in professional services such as dental centres, insurance agents, lawyers, optical centres and real estate brokers. Obviously some of these would not travel because of the difference in professional controls between countries. In the UK the most immediate new opportunities look like being in the computerised services such

as tax and business services related to the needs of the smaller business; fitness and health centres; specialist retailing; and perhaps even estate agents.

The British Franchise Association (BFA). The existence of this organisation, formed in 1977 by a number of leading British and international companies¹ engaged in the distribution of goods and services through franchise networks, is expected to contribute to the improved respectability² of franchising (and hence marketability and growth) in the UK.

Eighty or so of the 200 firms that operate franchise chains in the UK, have registered with the BFA, and by implication have agreed to its code of practice.

The BFA Code of Practice

1. The BFA's Code of Advertising Practice shall be based on that established by the Advertising Standards Association and shall be modified from time to time in accordance with alterations notified by the ASA.

Footnote

¹ The BFA's founder members were: Budget Rent-a-car, Dyno-Rod, Holiday Inns, Kentucky Fried Chicken, Prontaprint, Servicemaster, Wimpy International, and Ziebart.

² This respectability is proving hard to achieve. It has not been much helped by the recent failure of one of its founder members, and the BFA's 1982 Chairman's 70 outlets franchising chain going into receivership in 1985.

The BFA will subscribe fully to the ASA Code unless, on some specific issue, it is resolved by a full meeting of the Council of the BFA that the ASA is acting against the best interests of the public and of franchising business in general on that specific issue, in this case the BFA will be required to formally notify the ASA, setting out the grounds for disagreement.

2. No member shall sell, offer for sale, or distribute any product or render any service, or promote the sale or distribution thereof, under any representation or condition (including the use of the name of a 'celebrity') which has the tendency, capacity or effect of misleading or deceiving purchasers or prospective purchasers.
3. No member shall imitate the trade mark, trade name, corporate identity, slogan or other mark or identification of another franchisor in any manner or form that would have the tendency or capacity to mislead or deceive.
4. Full and accurate written disclosure of all information material to the franchise relationship shall be given to prospective franchisees within a reasonable time prior to the execution of any binding document.

5. The franchise agreement shall set forth clearly the respective obligations and responsibilities of the parties and all other terms of the relationship, and be free from ambiguity.
6. The franchise agreement and all matters basic and material to the arrangement and relationship thereby created, shall be in writing and executed copies thereof given to the franchisee.
7. A franchisor shall select and accept only those franchisees who, upon reasonable investigation, possess the basic skills, education, personal qualities, and adequate capital to succeed. There shall be no discrimination based on race, colour, religion, national origin or sex.
8. A franchisor shall exercise reasonable surveillance over the activities of his franchisees to the end that the contractual obligations of both parties are observed and the public interest safeguarded.
9. Fairness shall characterise all dealings between a franchisor and its franchisees. A franchisor shall give notice to its franchisee of any contractual breach and grant reasonable time to remedy default.
10. A franchisor shall make every effort to resolve complaints, grievances and disputes with its franchisees with good faith and good will through fair and reasonable

The BFA owes some of its inspiration at least, to the International Franchise Association based in Washington DC. Formed in 1960, this organisation represents 350 franchising companies world wide. There are now Franchise Associations in Belgium, Holland, France, Germany, Italy, Norway, Sweden, Switzerland, Canada, Japan, South Africa and Australia.