

Chapter 8

Franchising

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Learning outcomes

- Understand the meaning of the term ‘franchising’
- Briefly discuss franchising in South Africa
- Identify and discuss the different franchising models
- Understand and describe how franchises are classified in South Africa
- Compare and discuss various advantages and disadvantages of franchising
- Discuss how prospective franchisees can evaluate a franchisor and franchising opportunity
- Indicate what services the franchisor provides to his or her franchisees
- Describe and understand the reasons for franchising a business

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Learning outcomes (cont.)

- Assess whether or not franchising is the best option for expansion
- Identify and describe the steps to be followed when franchising a business
- Understand and discuss the financial considerations when franchising a business venture
- Discuss how prospective franchises can be evaluated by a franchisor
- Identify and discuss the elements of ongoing support to be given to the franchisee
- Understand and describe the impact of the Consumer Protection Act 68 of 2008 on franchising
- Understand the concepts of taking a franchise global

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Franchising defined

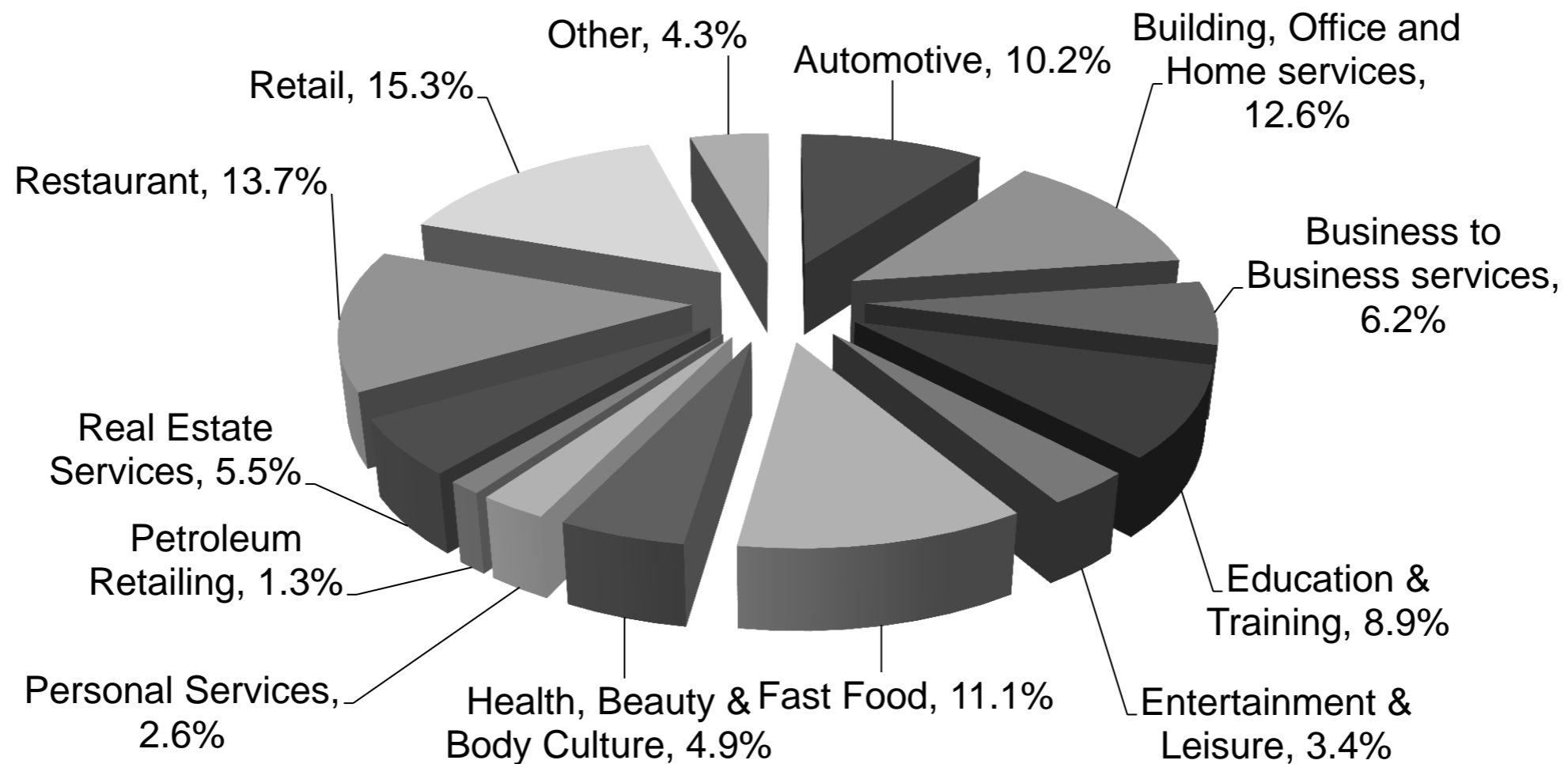
The word *franchise* originates from French and refers to *privilege or freedom*

FASA defines a franchise as a **grant** by the **franchisor** to the **franchisee**, entitling the latter to the **use of a complete business package** containing **all the elements necessary** to establish a previously untrained person in the franchised business and **enable him or her to run it** on an on-going basis, **according to guidelines** supplied, efficiently and profitably

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Franchising in SA



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Types of franchising

- Business-format franchising
- Product and trade-name franchising

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Business format franchise

Franchisor offers the franchisee a clearly defined packaged of deliverables and services. Usually included:

- Strong corporate identity – trademarks and logos
- Complete system to conduct business
- Hands-on assistance: site selection, staffing etc.

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Business format franchise

- Franchisee pays both upfront fee and continuing fees.
- Characteristics:
 - Most popular
 - Franchisor needs larger infrastructure
 - Expansion financed by franchisees
 - Examples: Spar and Wimpy

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Product and trade naming

With this type of franchise, the franchisee is expected to focus on the franchisor's product range.

- Warranty policies, service levels and appearance of outlet controlled by franchisor
- Franchisee may not sell a competing product
- Used in automotive, petroleum and soft drink distribution industries

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Franchise models

- Franchise models are discussed 161-165

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Classification of franchises

- Automotive franchises
- Building, office & home services
- B2B services
- Children's franchises
- Cleaning franchises
- Computer, Internet & cellular
- Education & training
- Fast food & restaurants
- Health, beauty & wellness
- Pet services
- Real estate & property
- Retail
- Sport and recreation

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Advantages of franchising

- On-going advice, training, research & development
- Reduced capital outlay with increased profits
- Brand awareness
- Buying power
- Infrastructure
- Business synergy
- Increased success rate
- Exit strategy

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Disadvantages of franchising

- Loss of independence
- Restrictions on products, pricing and location
- Ongoing royalties and advertising fees
- Balancing support with own ability to run business
- Damaged system-wide image = overall failure
- Duration is limited

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Disadvantages of franchising (cont.)

- Services could be expensive or non-existent
- Contract may protect rights of franchisor only
- Even with support cash flow may still cause the franchise to fail
- May be a fad or vehicle for fraud
- Franchisors do not fulfil initial undertakings
- Trade name not as valuable

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Finding the most suitable franchise

- Franchising Association of Southern Africa (FASA)
- Advertisements in newspapers and magazines
- Personal referrals
- International Franchise & Entrepreneurs Expo (IFE)

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Evaluate franchise opportunity

- Initial screening
- Access the franchisor's history - scrutinise the franchise business carefully to determine the following:
 - The chances for business success
 - Whether the franchise fee is justified
 - The potential long term profitability of the business
 - Whether the franchisor is really good at marketing and purchasing

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Evaluate franchise opportunity

- The product or service
- Financial aspects
- Market research
- Change of ownership
- Franchise support provided by the franchisor

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Franchise support

The franchisee should expect at least the following:

- The operations and procedures manual
- Assistance in finding the right franchise facility
- Guidance during the establishment of the unit - necessary specifications
- Adequate training of the franchisee and key staff
- Continuous advertising and promotion of the brand name
- The availability of a field force of the franchisor that can provide good business advice and is able to support the franchisee during a downturn

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Franchising a business

- Preliminary planning
- Establish network potential
- Financial projections
- Setting up franchise fees

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Establish network potential

- Identifying the target areas for expansion and assessing the potential of each of these target areas
- Ranking the areas according to potential – consider logistical constraints that may negatively impact ability to service and support franchisees in these areas
- Timelines and milestones for the development plan, with due consideration of commercial realities that may impact the development plan
- Careful planning should take place to guard against over-saturation of an area

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Financial projections

- Projections from pro forma financial statements and profit and loss account
- Cash flows for the first three to five years of operation
- Develop a sound business plan - address the different costs and projected income related to the franchise
- Establishment of a franchise infrastructure requires substantial initial investment by the franchisor

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Setting up franchise fees

- Upfront fee
- Renewal fee
- On-going fees
 - Income from management fee; additional income (rent, build to equip etc.); income from product supplies; income from administration & accounting services
- Network marketing fund

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Estimated costs to be incurred during the period the franchise project is in preparation	/	Projected number of units to be established during the first three years	=	Initial fee
+ costs (projected for three years) of recruiting and training franchisees				
+ costs (projected for three years) of providing set-up assistance				
+ charge of goodwill (arbitrary figure set - keeping brand value in mind)				

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Network marketing fund

- Central marketing fund operated by the franchisor on behalf of the network
- Earmarked for product advertising to the benefit of the network
- All franchise outlets will gain equally from group advertising
- May be paid as a fixed amount or as a percentage of turnover
- Paid on a regular and continuous basis

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Franchisee recruitment

1. Generate enquiries
2. Set follow-up procedures in motion
3. Invitation to a meeting
4. Enter into concrete negotiations
5. Formal agreement

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Generating enquiries

- Develop a franchisee-information aimed at prospective buyers and their professional advisors
- Introduce and present your franchise at seminars and exhibitions
- Compile an introductory visual presentation (on videotape or DVD)
- Offer to speak at small-business events and provide the press with information about your franchise
- Advertise in newspapers and magazines and with FASA

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Set follow up procedures in motion

- Determine who will deal with initial enquiries
- Keeping a record of every franchise enquiry; provide prompt response
- Keeping track of promising enquiries
- Reacting in writing when further information is requested by enquirers
- Send questionnaire for completion by the enquirer – after it has been returned, look into the applicant's background, financial standing, and any references provided
- Start the follow-up process by inviting the applicant to attend an initial interview

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Invitation to a meeting

During the personal meeting:

- Give the applicant in-depth information about your business opportunity
- Show company-owned unit
- Discuss the necessary investment in broad terms
- Encourage him/her to ask questions (do not offer detailed financial information)
- Assess his or her potential for your organisation

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Enter into concrete negotiations

- Positive negotiations: offer comprehensive information folder to entrepreneur
- Entrepreneur should sign the Initial Undertaking (dated to record the receipt of the Disclosure Document)
- Agree on the location of the unit
- Prepare customised financial projections and statements (including earnings requirements of the franchisee and other specifics)
- Encourage the prospect to discuss the disclosure document, financial figures, and franchise agreement with professional advisors
- Stress confidentiality obligations

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Formal agreement

- Once all details finalised sign formal franchise agreement
- After the agreement has been signed, the following should be done:
 - Bank the cheque for the upfront fee
 - Schedule the franchisee's training
 - Set the 'start-up assistance package' in motion

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Franchise package

- Disclosure document
- Franchise agreement
- Operations and procedures manual
- Cooling-off period

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Disclosure document

The Disclosure Document contains:

- Directors' and key executives' business experiences
- Company's track record
- Description of the franchise
- Initial investment required
- On-going payments due to the franchisor
- Termination, renewal, goodwill or assignment of agreement

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Disclosure document (cont.)

- Number of existing franchisees and their success rates
- Franchisor's assistance in selecting approved sites
- Training and support guaranteed to the franchisee
- Financial information about pilot operation
- Financial data on the franchisor
- Certificate from auditor or accountant on business being a going concern
- Confirmation of directors on viability of the system
- Total investment required (indicating all costs)

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Franchise agreement

- Parties (signatories) involved in the agreement and their relevant objectives
- Period of the agreement and the right to renew or extend the contract
- Set-up requirements such as obtaining finance, renovating the premises, shop equipment, legal obligations, and so forth
- The rights to sell or transfer ownership of the franchise
- Obligations to the franchisor, such as buying supplies or services
- Construction and functioning of the franchise – hours of business, look and feel etc.
- Terms and conditions for termination of the contract (breach of contract)

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Franchise agreement (cont.)

- Description of exact training and support offered
- Precise price, commissions, and rental fees involved
- Precise boundaries of the territory awarded, if any
- Functioning of the franchise: management, involvement of franchisee, and right to sub-franchise
- Operating systems guiding and driving the franchise
- Accounting system to be used
- Description of your heir's rights in the event of your death
- Definitions of all terminology that will be used repeatedly throughout the document

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Franchise agreement (cont.)

- The franchisor may require that the franchisee records upfront, prior to the execution of the agreement, that he or she:
 - Has read the provisions of the agreement and fully understands them
 - Has been advised by the franchisor to obtain independent legal advice on the terms of the agreement
 - Has not relied on statements or representations made by the franchisor, its employees or agents, other than those recorded in the agreement and disclosure document

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Franchise agreement (cont.)

- Understands that none of the assistance rendered by the franchisor should be construed as a warranty for the successful conduct of the franchised business
- Understands that the success of the franchised business depends largely upon the abilities and efforts of the franchisee to operate it successfully

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Operations and procedures manual

- An introduction to the franchise
- Step-by-step guidelines
- The production equipment
- All details regarding stockholdings, systems and controls, pricing methods
- The business operation where the franchisee is obliged to meet specific operational standards
- The accounting and administration system to be used
- The duties of the franchisor
- Industrial relations

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Cooling-off period

- A cooling-off period of 14 days must elapse between the day the prospective franchisee receives the Disclosure Document and a copy of the Franchise Agreement, and the day on which any binding agreement can be entered into or on which the franchisor may accept any payment from the franchisee.

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Start-up assistance package

- Pre-opening assistance
- Statutory requirements
- Staff selection and training
- Moral support
- Opening promotion

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On-going support

- Training
- Group-purchase arrangements
- Marketing and advertising
- Trouble-shooting
- Market and product research
- Administrative systems
- Communication

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Competition legislation

Impact on franchise practices:

- Price-setting agreements
- Tying agreements
- Exclusive dealing
- Territorial restrictions
- Clauses protecting know-how and other intellectual property
- Benefits & unique situation of franchises & clauses of franchise agreements

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The CPA and franchising

1. A notice on top of the first page of the agreement must refer to the 10-day cooling-off period franchisees are entitled to and state the relevant section of the Act
2. The franchise agreement must contain provisions preventing unreasonable fees and unnecessary conduct
3. The name and description of the goods/services and obligations of both parties

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The CPA and franchising (cont.)

4. Information about the franchisor's directors, members or equivalent officers
5. Full particulars of the financial obligations that the franchisee incurs
6. Any direct or indirect benefit a franchisor stands to receive

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International franchising

- **Assess feasibility**
- **Develop a master licence:** grants the right to open a business in entire country
- **Assess the country:** Size of potential market; sufficient interest; attainable margins; suitable prospect
- **Investigate licensee:** investigate potential purchaser of licence
- **Involve support systems**