Keys to Understanding Franchising

Which Franchise is the Best Fit for You?

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From the Researchers behind:

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FRANdata Franchise Business Intelligence

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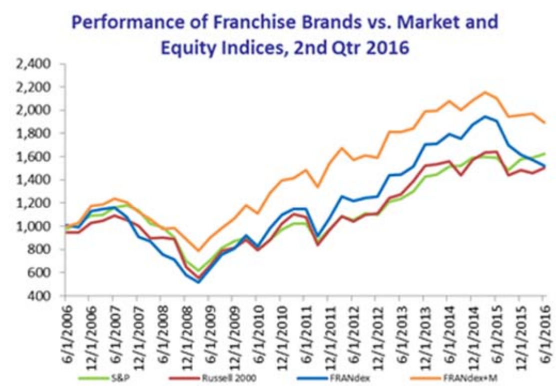
Franchise Overview

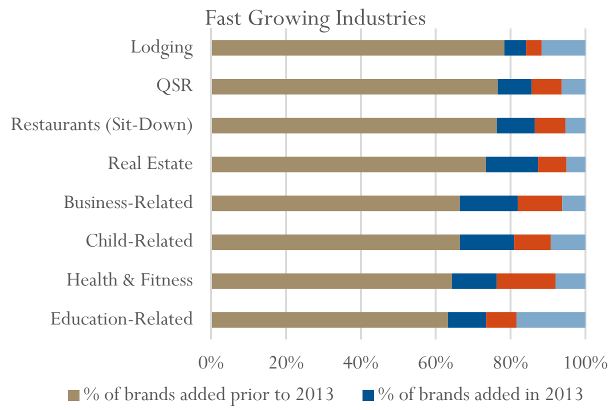
We at FRANdata have been studying franchising for the past 25 years, so it is with some bias that we always think that the right place to start when you are in the market for a franchise is to be knowledgeable of the market itself. The franchise universe in the United States is made up of what we estimate to be 7,000-10,000 brands. According to the IFA (The International Franchise Association) there is more than 733K franchised units in the United States and that number grows every year. Franchising provides millions of jobs and is the largest source for vocational training in America.

FRANdata publishes a quarterly report that studies the performance of publicly traded franchise brands and compared their market performance to other indexes such as the S&P and Russell 2000. FRANdex has consistently outperformed the other indexes for years now.



That being said, these aren't your dad's franchises anymore. Franchising is evolving beyond what is commonly considered a franchise. New franchise brands entering the market cover industries beyond just fast food. In the past three years, diverse industries saw the most activity, from healthcare and education brands, to tobacco products and pet services brands. Demand for these industries is closely tied to rises in disposable income and broader improvements in the national economy. In addition to an improving economy, advancements in technology have created opportunities and efficiencies that has driven growth in these growing industries. New brands entering saturated markets are specializing in niche products and services that often target a specific customer base, to differentiate their brand from the masses of existing brands already in the market. Now when we think new brands, we think specialization and diversification.

Emerging Industries and Trends



- Tobacco Related Products – 12 of the 14 brands in the sector entered the market after 2013
    - Palm Beach Vapors entered the market in 2013 as one of the first e-cigarette retail concept to start franchising. The brand is paving the way in the medical marijuana industry, recently licensing their M-system technology to franchisees that operate Palm Beach Vapor stores in states that have legalized marijuana. The M-System is a patent pending cannabis crossover technology developed by their affiliate company, Native Grow LLC.

- Pet-related Products & Services – added 21 brands since 2013, amounting to 34.4% of the industry
    - Pet parents and owners are increasingly considering their pets as part of their family. Coupled with more disposable income, pet parents are able and willing to pamper and spend more on premium products and services for their furry loved ones.
    - In response to this growing demand, new pet related franchises focus more on premium services, like dog walkers, pet sitters and daycare, and pet grooming services. Paw Beach Pet Resorts is a luxury dog and cat lodging business, where parents can rest assured knowing that Fluffy is relaxing in a resort environment, enjoying water activities and freshly made treats.
        - *Example:* K9s Only is an all-inclusive destination for dogs only, that offers raining, boarding, grooming, massage, daycare, swim lessons, and aquatic rehabilitation
        - *Example:* Lucky Dog Bark and Brew! Provides a place for dog owners to relax and have a drink at their sports bar while their pets enjoy the full service dog daycare, boarding and grooming facility, featuring an indoor and outdoor dog park.

- Medical & Healthcare Services
    - A recent surge in medical and healthcare brands entering the market may be attributed to the reforms in US healthcare industry and a shift in the payment structures to a value-based model. These new brands offer lower-cost, specialized medical and healthcare services, such as E3 Elite Rehab Systems, which treats neck and back pain and certain spinal disorders.
        - *Example:* Centro Clinic businesses provide bilingual chiropractic care centers by licensed chiropractors. The English speaking market for chiropractic treatments is well developed and competitive. The Centro Clinic targets a niche market, providing care and treatment to

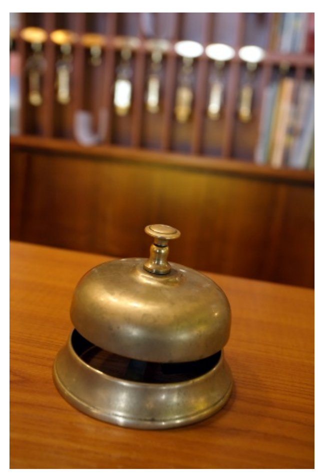
Spanish speaking and minority populations with primary emphasis on auto accidents and workers compensation injuries, facilitated insurance and accident compensation, and patient and referral satisfaction.

- Technology innovations and the industry's investments in big data have also paved the way for new brands like Go Telecare, which sells medical billing services and telehealth services.

- Education Related & Children's Educational programs
  - Education reform has been a hot topic in national media and politics for some time. US students are falling behind students in other countries, especially in STEM (science, technology, engineering and math) subjects; many parents are looking to the private sector to help their kids excel academically and prepare them to join the high demands in labor for these top growing technical industries

  - Entrepreneurs and franchises are filling the gaps and bringing innovative new ideas, programs and technologies to the table that reshape the way we educate America's youth
  - Just like Uber disrupted the transportation industry, the education industry is looking for a similar push
    - *Example:* The Little Medical Schools conduct after school and summer camp programs that feature medical themed projects, that give children (5-10 years old) a fun and interactive head start to understanding medicine, science and the benefits of good health.
    - *Example:* theCoderSchool teaches kids how to code in various languages with a focus on logical thinking and collaboration for children ages 8 through 18.

- Lodging – added 26 brands since 2013 (opened by 8 franchisors), amounting to 21.7% of total industry
  - The improving economy has given rise to business and leisure travel, which has opened the doors for new hotel concepts to enter the market
  - Franchisors are diversifying their portfolio of brands to offer concepts that fit the lifestyles and preferences of diverse customer profiles (luxury brands vs. lifestyle brands)



    - *Example:* Hilton started two new concepts, Canopy by Hilton is in the upper upscale market catering to business travelers, families and vacationers. Hilton's new Curio brand is a lifestyle concept targeted at emerging and millennial travelers who are more cost-conscious and focus more on the experience and authenticity than luxury services. With a focus on authenticity, Hilton's new Curio brand allows individual hotels to embody the spirit and culture of their market and retain their independent character, catering to local customer desires.

- Health & Fitness – added 107 brands since 2013, amounting to 35.7% of total industry
  - Growth in the industry is not unprecedented but there has been a shift from big-box gyms to boutique/specialized fitness centers
    - New concepts offer a complete package of services and classes in addition to access to equipment; often specializing in niche services that feature proprietary technology, training programs or workout routines that differentiate the concept from the masses of existing fitness centers

- Sit-down Restaurants – added 93 brands since 2013, amounting to 23.7% of total industry; while QSR brands added 111 new brands, amounting to 23.4% of the total industry
  - While the QSR industry has the most brands overall, followed closely by sit-down restaurants, the sit-down restaurant industry is catching up to QSR
  - Sit-down restaurants, on average require double the initial investment than QSR, but also generate twice the revenues once in operation
  - Italian food is most popular among new food brands in general – the Italian sit-down restaurant and QSR pizza sectors added the most brands since 2013

- Business related services – added 54 brands since 2013, amounting to 33.5% of the total industry
  - Most new brands added in the advertising and promotion sector and tax services sector
  - Improvements in overall economic health triggered business expansion, increasing business spending levels, which drives demand in the industry
  - Technology innovations have created efficiencies and opportunities in the industry, making profitability easier to come by
  - Business services concepts are more accessible and generally require lower initial investments and can often operate out of a home office

- Real Estate – added 21 brands since 2013, amounting to 26.6% of industry
  - Growth driven by improvements in the housing markets
  - The franchise model offers a consistency that people can trust – while offering entrepreneurs turn-key business opportunities in industries they may not have experience in

Before You Invest

Multiple decisions come into play for the typical person who is looking into investing in a franchise. If you have decided that franchising is for you here are some questions you need to ask yourself as you explore your options- most of the answers can be found via research, the brands' Franchise Disclosure Document, or by simply asking the franchise –

Choosing an industry

- Size
  - How large is the market?
  - Are territories saturated?

- Competition
  - How many brands are there?
- Trends
  - Where is the market going?
  - Historical/global economic trends?

Choosing a Brand

- Mature Brands
  - Larger, more established system have more national brand recognition
- Growth Brands
  - Could be regional concepts, with a much smaller footprint
- Emerging Brands
  - Proof of concept
  - Right management team experience and mix

Mature brands: Might have an added cost to remodel in case of refranchises. Look at Wendy's or Burger King or Taco Bell. All legacy franchises with growing opportunities but with remodel requirements.

Growth brands: Could have incentives in place for adding units in territories outside its regional footprint. ZIPS Drycleaners is perfect example. Signed development of 104 stores throughout the Mid-Atlantic and Midwest with one multi-unit franchisee.

Understanding What Your Management Role and Operations Will Be

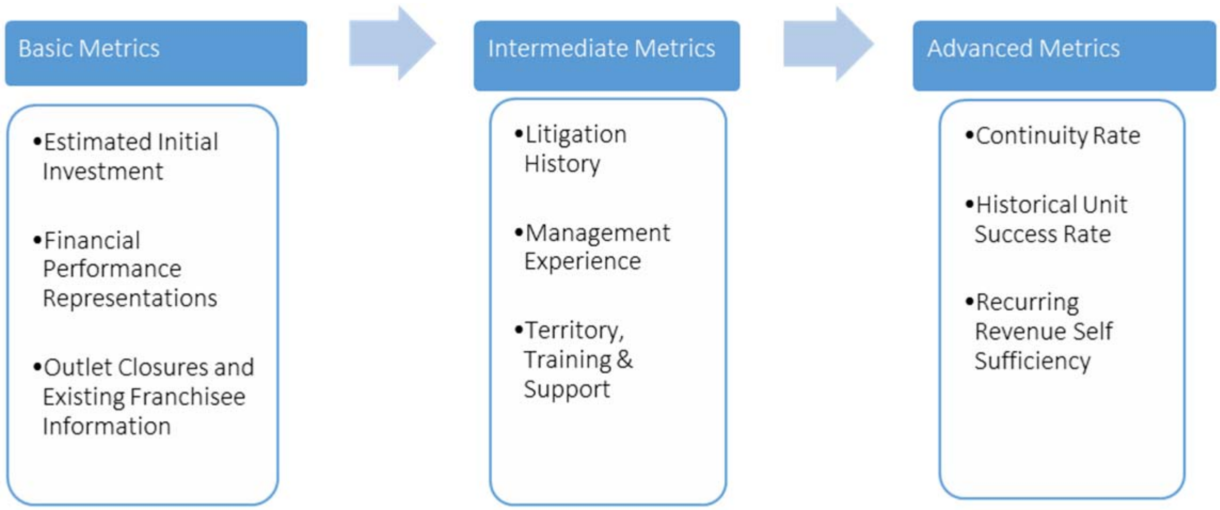
Different franchises have different expectations and systems for their franchisees. For instance Culver's requires operators to maintain at least 50% ownership in the business, or at least 25% in the business and real estate, and be involved full-time in day-to-day operations. The types of operators which you may encounter are:

- Owner-Operator
  - Equity investment in the operations

- Single Unit/Multi-Unit
    - Only 45% of franchisees across industries are single-unit operators
- Territory/Area Developer
    - Receive share in royalties and initial fees for every unit franchises sold

Analyzing Performance Metrics

Much like starting any business or even in the case of investing in stocks, understanding the “numbers” behind the franchise gives good understanding as to what you can expect when you buy into a concept.



Demystifying The Franchise Disclosure Document

The franchise disclosure document (FDD) is a legal document which is presented to prospective buyers of franchises in the pre-sale disclosure process. Not all FDDs are created equal, some disclose more than others and some might even contain dated information. Through this section you will be able to understand what you can find in an FDD or at least be able to ask for the information if for some reason it is not disclosed during your due-diligence process. The FDD is divided into different sections or “Items” – each Item focuses on a particular category of the business. Below are the sections/Items and the specific information you need to look for which we think are of particular importance when studying a franchise.

FDD Item 7: Estimated Initial Investment

- Startup costs
- Fixed vs. mobile
- Traditional vs. non-traditional
- Lease vs. purchased real estate

Look out for brands whose costs fall outside the range disclosed in the Franchise Disclosure Document. Franchisor should have concrete explanation about such extremes.

FDD Item 19: Financial Performance Representations

- Does the brand have one?
- If not, why? If so, what does that tell me about the brand?
- Do they report company-owned vs. franchised locations?

This is the most important metric to a lender when it comes to financing operations. Lenders tend to focus on cash flow rather than gross sales

FDD Item 19: Financial Performance Representations

- System wide outlet summary
- Franchised vs. corporate outlets
- Breakdown by state

Examine the "ceased-other" and terminations within a system. Lenders tend to cap this at 5% of the total franchised units

FDD Item 3: Litigation History

- Franchisor-franchisee relations
- Pending, current, and concluded cases

Examine the franchisor-initiated litigation. A highly litigious franchisor can lead to loan defaults

FDD Item 2: Management Experience

- Who is in charge?

- What is their expertise?
- What is their background?
- Do they have experience managing a franchise system? Or were they franchisees once themselves?

Examine longevity, and franchise/industry experience of the franchisor's management team, because that's what lenders do and this will reflect on their ability to use their skill and experience in managing a thriving franchise system.

FDD Item 10,11 &12: Territory, Training & Support

Do they Offer:

- Financing Assistance?
- Pre-opening Support?
- Training Hours?
- An Advertising Fund?

Examine the territory restrictions. Can a competing unit open where new franchisees are planning to open their locations? Ideal franchisor has to have a site approval package.

Franchise System Continuity Rate

- Indicator of ongoing success
- How many franchised units are retained?
- Helps support your case to landlords

A continuity rate of 95% or above is considered high in franchising

Historical Unit Success Rate

- Assesses the overall health of a franchise system
- Adjusts for units failed due to operational issues

Brands in the top quintile across franchising have a compounded Historical Unit Success Rate of 91% or above

Recurring Revenue Self Sufficiency

- Excludes financials associated with selling new units
- Do recurring fees cover corporate overhead?

A self-sufficient franchisor does not rely on adding new units to cover its ongoing costs

Beyond the FDD

As you probably realize now, there are many questions that need to be answered in your quest for a franchise that will be a good fit for you. The more you understand the better equipped you will be to move forward. On the plus side, there is no lack of sources of information if you are clear with what you are looking for. Below are the more qualitative sources that you can refer to--

- Secondary Research on the Franchisor and the Brand
  - Franchise Business Review
  - Franchise Times
  - Franchise Update
  - Forbes
- Attend franchise events and conferences to speak directly with franchisor representatives and peers
  - These events also offer sessions where you can learn more about getting into a franchise and the opportunities available in your market
- Network with existing and previous franchisees
  - Why they left the system?
  - Support and franchisee satisfaction
  - Qualitative Information is INVALUABLE!!!!

Understanding the Franchise System you are buying into also needs an understanding of what you want your investment of money, time, and effort to be:

- *How much support do you want or need from the franchisor?*
- *How much initial investment dollars are you able to part with?*
- *How reliant on loans will you be in order to open a franchise? (the more reliant you are the stronger the franchise needs to be in terms of support and performance history)*
- *What skills or experience do you bring to the table? Will it complement the franchise concept?*
- *Do you have an area or location in mind? Or are you looking for a business you can operate from home?*