Fast food franchising—Fool's gold or fortune?

Contributed by: ROBERT S. GLOVER

The author has examined the operations of a number of fast food franchise operations, large and small. The article presents a current evaluation of the nature, operational methods, and benefits to be gained from a fast foods franchise, as well as pointing out some of the problems that may be encountered.

Introduction

Franchising is a method of distributing goods or services in which the owner (franchisor) of goods or services grants a license to independent businessmen (franchisees) who become retail distributors within a specified geographic area. The goods or services are sold under a brand name established by the franchisor, and the franchisor provides the franchisee certain services and management assistance on a continuing basis. The franchisor has some degree of control over the distribution of the goods or services and can, to some extent, regulate the activities of the franchisee. Both the franchisor and franchisee generally assume certain financial risks and both are in a position to gain from a successful operation.

Franchising is an old concept and method of business operation. It is known to have existed in the United States during the Civil War era and become widespread shortly after 1900 when it was employed in the distribution of automobiles and gasoline. A more recent period of expansion for franchising began about 1950, and it has been estimated that franchised business is now approaching $100 billion in annual sales and exceeds 25 percent of all retail sales.

Food service outlets and fast food restaurants account for a significant segment of this recent growth of franchise operations. Presently, about 26,000 such retail establishments provide the public fast service and inexpensive food (fried chicken, hamburgers, hot dogs, pizza, fish and chips, steak, donuts, ice cream and various other items). The number of these outlets is continually increasing and more are reportedly being planned.

Virtually all food service franchisors can cite impressive examples of individuals of limited means who became quite successful as food service franchisees. The "rags to riches" experience of some suggest that the rapid development of fast food franchising may be the answer to the American dream of owning one's own business.

While it cannot be denied that the possibility exists for individuals of rather limited finances to enter fast food franchising and become successful, caution should not be discarded when considering a franchise opportunity as all who tried the business in the past did not succeed, and some who become franchisees in the future will undoubtedly fail. This will most certainly be true if economic conditions similar to those of 1970 and early 1971 continue. Recent months have not been particularly prosperous for fast food franchising (the business is not unique in this respect) and failures appear to be increasing.

Individuals who fail as franchisees may suffer serious personal financial setbacks that present problems for their families and creditors. Franchisors may be less seriously damaged when a franchisee fails, but generally have little to gain from this result. Consequently, fast food franchising in its entirety, would benefit if the failure rate of franchisees could be reduced.

A number of factors undoubtedly influence franchisee failures. One contributing factor is the prospective franchisee's lack of knowledge of franchising as a method of business operation and of the alternatives available in fast food franchising.

The risks inherent in owning a franchised fast food outlet make it imperative that individuals initiate sound business management practices *prior to* entering a franchise agreement. This prior planning should involve giving consideration to both the possible advantages and disadvantages associated with becoming a franchisee.

Information for this article was furnished by food service franchisors. Letters requesting pro forma income statements and materials that explain the purposes and policies of their companies were sent to 176 franchisors. Responses were received from 45 franchisors with 38 of these providing part or all of the written information they typically furnish prospective franchisees. While the number of firms that responded comprise a relatively small percentage of the fast food franchisors now in operation, most of the large nation-wide firms did provide information. Thus, the article hopefully presents an accurate description of fast food franchising as it existed in the early 1970s.

General Questions About Franchises

1. *How much does it cost an individual to establish a franchised fast food restaurant or drive-in?*

The cost of becoming a local franchisee depends primarily on which franchisor is to be represented. As might be expected, the cost of representing well-established, nation-wide companies is generally greater than for less well-known, regional or local companies.

An initial franchise fee is paid to the franchisor and accounts for a portion of the investment of the franchisee. The franchisee fee is in part a license fee, as it typically gives the franchisee the exclusive rights to sell the franchisor's products, use the franchisor's recipes,

Table I. Amount Invested, Annual Gross Sales and Annual Net Income Relationships Reported by Three Franchisors.

	- - - - - Annual Gross Sales - - - - -						Investment Necessary for Outlet (cash plan)
	$125,000	$175,000	$225,000	$250,000	$300,000	$400,000	(dollars)
FRANCHISOR A:							
Annual Net Income (dollars)[1]	14,450	23,497					
(percent of gross sales)	11.6	13.4					35,000
FRANCHISOR B:							
Annual Net Income (dollars)[1]		20,470		41,716	59,496		60,000
(percent of gross sales)		11.8		16.7	19.8		
FRANCHISOR C:							
Annual Net Income (dollars)[1]		4,899	21,205		44,220	67,085	90,000
(percent of gross sales)		2.9	9.0		15.0	16.9	

[1]/Before income taxes

store designs and colors, as well as signs and symbols in a specified geographic area. The initial franchise fee grants the franchisee these rights for a specified time period, frequently 15 to 20 years. This initial fee can vary from $2,000 with some franchisors to $20,000 with others. In addition, there is usually a continuing license fee (or royalty) that is paid to the franchisor each month the franchisee is in operation. This fee is usually based on the month's gross sales volume and ranges from less than one percent to five percent, depending on which franchisor is being represented. Some franchisors do not charge a continuing fee as such but receive regular payments from franchisees through the sale of supplies (mostly paper goods and food products).

Franchisors usually offer two plans through which an investor can become the owner of a local franchise. These are:

A. All cash plans in which the franchisee pays cash for everything that the contract specified he will receive from the franchisor (the so-called "franchise package"). This will generally include certain rights, assistance and operating equipment. The cost under these plans can vary from as little as $18,000 to over $100,000, depending on the company involved in the transaction.

B. Cash-credit plans whereby the franchisee in effect makes a cash down payment when the franchise agreement is completed and finances the balance over a period, often three to five years. The costs of purchase and installation of operating equipment usually comprise a significant portion of the franchise package and are often partially financed. The cost at the time of opening an outlet under a financing plan varies from under $10,000 to about $65,000, again depending on the company involved.

2. *What does the investor get in the "franchise package"?*

The actual rights and privileges granted and property purchased with the closing of a franchise contract vary among franchisors, but the following are often included.

A. Cost of plans and specifications for buildings and other improvements.
B. Formal training for managers and/or assistant managers.
C. Assistance in interviewing, employing, and training of other employees.
D. Standardized record-keeping and cost-control systems.
E. A grand opening advertising campaign and continued local area advertising. (Television network advertising is provided by some of the larger franchisors.)
F. The advantages of volume purchasing of food supplies and paper goods.
G. Professional advice and consultation on site selection and preparation.

Land and building costs are usually not a part of the initial cost of the package as these are leased to the franchisee by the franchisor or a third party. However, the franchisee may be required to make a security deposit against the lease, a rent security bond, or payment of rent in advance. These may range from $2,000 to $15,000.

Ownership of the exterior signs used by the local outlet (and required by the franchisor) is usually retained by the franchisor and rented to the franchisee. Consequently, this cost is not an initial cost.

3. *What returns can an investor expect from the ownership of a franchised fast food restaurant or drive-in?*

Franchisors frequently provide tentative, i.e. pro forma, income statements containing sales projections, cost breakdowns, and profits to prospective franchisees.

Some franchisors base these statements on the experience of their existing outlets while others devise statements via methods (perhaps guesses) that may be less indictive of the likely performance of a prospective franchisee.

The different franchisors seldom use identical methods of developing the income statements; consequently, limited information can be obtained through direct comparison of the statements. In spite of this, it seems evident from the review of a number of statements issued by franchisors that net annual income is generally influenced by gross annual sales which are usually related to initial investment. The expected earnings from

ROBERT S. GLOVER *is Extension Market Development Specialist, University of Georgia. Formerly he was Assistant Professor of Agricultural Economics at Stephen F. Austin College (1957-1959), and at Auburn University (1965-1968), and Associate Professor of Economics, Austin Peay State College, (1959-1965). Dr. Glover is a member of the American Economic Assn., American Farm Economic Assn., and the American Marketing Assn. His current activities are primarily devoted to assisting agri-business firms in the development and promotion of consumer products.*

typical outlets of three different franchisors are shown below and illustrate these relationships.

Basic economic factors lie behind this relationship between the amount invested, annual sales, and net returns. These data above also illustrate the importance of choosing a retail outlet that is suitable for the size of the market. For example, if a prospective franchisee estimated that an annual sales of $175,000 could be achieved by establishing an outlet at a particular site, and if he had the choice of becoming affiliated with either of the franchisors above and wanted the highest net earnings, he would select Franchisor A. If the market potential was estimated to be greater than $175,000, he would select Franchisor B or C, depending on his actual estimate of annual sales.

The income statements provide other meaningful information. The figures below were derived from the pro forma statements furnished by franchisors and show cost breakdowns and net income as percentages of annual gross sales.

Table II. Cost and Net Annual Income Estimates Reported by Franchisors

Gross Sales and Cost Categories	Cost as a Percent of Annual Gross Sales[1]
Gross Sales	**100 Percent**
Cost of Sales	38.0 — 42.0
Food	35.0 — 41.0
Paper	2.0 — 4.0
Operating Expenses	35.0— 45.0
Salaries and Wages (including payroll taxes	17.0 — 23.0
Rent	6.0 — 8.0
Advertising	3.0 — 4.0
Royalty or Franchise Fee	3.0 — 4.0
Store Supplies	1.0 — 2.0
Utilities	1.5 — 3.0
Taxes and Licenses	0.5 — 2.0
Interest	0.8 — 1.2
Depreciation	2.0 — 3.5
Repairs and Maintenance	0.5 — 1.0
Sign Expenses	0.5 — 1.0
Other and Miscellaneous	0.4 — 2.0
Net Annual Income	14.0 —23.0

Note: Percentages do not add up to 100.

[1]Most of the reporting franchisors estimate that each cost and net returns will be within the stated range when the outlets are operated in accordance with company policy and procedure.

Indications suggest that different franchisors expect a particular cost category (as a percentage of gross sales) to vary widely. Nonetheless, the particular costs reported by *most* franchisors cluster rather closely. For example, food costs as reported by different firms may range from 27 to 44 percent of gross sales while a majority of firms estimate this cost to be between 38 and 42 percent.

Franchisors undoubtedly cannot predict the net earnings of a proposed outlet with perfect accuracy. It does appear, however, that most franchisors expect their franchisees to attain a level of annual sales that will enable the franchisee to earn between 14 and 23 percent of gross sales annually.

Caution and the Franchise Contract

The provisions of a franchise contract not only vary from franchisor to franchisor, but a single franchisor frequently has available contracts that contain different stipulations. Thus, the number of contracts in existence precludes a detailed discussion of such contracts that could be entered into by a prospective franchisee. Notwithstanding this, there are certain precautions that any individual should follow before entering into any franchise agreement. These include:

1. Seek the advice and counsel of an attorney (some franchisors insist that the prospective franchisee do this). After studying the document, he can advise you on the legal fine points.
2. Learn all you can about the franchisor's financial strength and business reputation. Consult with bankers and representatives of other financial institutions that may have knowledge of the firm. Visit several of the franchisor's outlets that are similar to the one planned and talk to the franchisees about the company.
3. Know exactly what aids and services the franchisor offers the franchisee both in establishing and opening the outlet and on a continuing basis. Ask the franchisor, "Just what am I to get from you?" and insist on detailed answers to this question. Do not expect anything from the franchisor that is not spelled out in the contract.
4. Investigate the prices the franchisor charges for restaurant equipment. Clarify the franchisor's pricing practices for food, paper goods and other services furnished the franchisee on a continuing basis.
5. Have the franchisor explain how and where the company makes its profits.
6. Be certain you understand the contract provisions relative to the duration of the agreement.
7. Understand the termination clauses of the contract. Determine if goodwill is considered when you sell the business. The franchisor may assume that the reputation and trade of an outlet is a result of his (the franchisor's) advertising and promotion. Thus, the franchisee is not paid for goodwill. If goodwill is not considered, you would sell essentially inventory and equipment. Know how the value of equipment is generally determined when outlets of the franchisor are sold. If book value is used in determining selling price, you may sell for considerably less than its value as useful equipment.
8. Know the rate schedules of continuing franchise fees or royalties. Do the rates change from year to year? Do they change when gross annual sales vary? Does the contract call for a minimum annual royalty regardless of gross sales?
9. Investigate the franchisor's advertising policy–know how much and what type of local advertising he requires and know how he spends your money for regional or national advertising.
10. Know exactly what territorial rights are granted you by the contract. Where and when can the franchisor establish additional outlets near you?
11. Learn what the status of your outlet would be if the franchisor merged or was consolidated with other firms. Would all the contract commitments be binding after the merger?

IV. Points to Remember

This article does not attempt to bring into focus and answer all pertinent questions that may confront a prospective fast food service franchisee. It is believed, however, that some of the major considerations a novice would face have been introduced.

It is appropriate to close with the following reminders for those who are thinking of becoming franchisees.

1. Franchising itself is a business. Some franchisors may be more interested in selling franchises than in food service. The franchisor may be much more interested in franchise fees than in french fries. You, as a prospective franchisee, may be the franchisor's customer, not the consumer's who would buy the food products of your outlet. The importance of a thorough investigation of the franchisor cannot be overemphasized.
2. Franchisors require a very high degree of uniformity in the food products sold in their outlets (franchisors insist that the consumer gets the same hamburger from an outlet in Oregon that he gets from an outlet in Florida). This type of standardization requires control on the part of the franchisor.
3. Franchisors have numerous means of making profits —through franchise fees, royalties, the sale of food and paper supplies to franchisees, and lease income among others. The franchisee usually has one means of profit—through food service.
4. Successful franchisees usually devote long hours to the operation of their outlets. This effort often involves other members of the franchisee's family. Family cooperation contributes to success.
5. The franchisee being an "independent businessman" is probably more myth than reality. Individuals that place a high value on being independent should take a very hard look before becoming a franchisee. Operating a fast food franchise is more likely to be suitable for people who place a high value on getting a relatively high income and to obtain this, are willing to accept considerable control from a large organization.
6. A franchisor may grant you an exclusive territory and assure you that his main food item is unique because of the recipe, method of cooking, etc., but remember your food must compete with that of rival franchisors. For example, if you sell the products of Franchisor A, it may be guaranteed that no competitor will sell Franchisor A's hamburgers in your territory, but the hamburgers of Franchisors B, C, D, and E may be readily available. This may not be a serious problem if the franchisor you become associated with is well known and the food you will sell is truly unique. Will this be the case?

SELECTED REFERENCES

Fortune, "Franchising's Troubled Dream World," March 1970, Volume 81, No. 3, pp 116-121.

Time, "Franchising: New Power for 500,000 Small Businessmen," April 18, 1969, Volume 93.

U. S. News and World Report, "A Business of Your Own — The Growth of Franchising," December 8, 1969, Volume 67, No. 23, pp 56-69.

Rosenberg, Robert M., and Madelon Bedell, "Profits from Franchising," McGraw Hill, New York, New York, 1969.