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WHY NEW FRANCHISORS SUCCEED

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Purpose

Franchising currently accounts for more than one-third of all retail sales in the United States. The growth of franchising as a business form has led more and more Americans to purchase franchise outlets as a way to become entrepreneurs. Each year between 200 and 300 companies seek to meet this demand for franchising by offering franchises for sale for the first time. The study examines why some new franchisors survive and grow, while the vast majority fail: approximately three-quarters of new franchise systems cease to franchise within 12 years of beginning to franchise. The goal of the study is to determine the characteristics of successful franchise systems to help entrepreneurs in their decision-making about investing in a new franchise system.

Scope and Methodology

The study tracks 157 representative companies that began franchise systems between 1981 and 1983 to determine their experience to 1995. The list was obtained from Bond and Bond's Sourcebook of Franchise Opportunities. The firms were drawn from 27 different industries; the most common industry was eating and drinking places, with 37 new franchisors in the sample.

The average new franchisor in the study was seven years of age when it began to franchise, and it had 4.82 company-owned outlets. Its average advertising and royalty rates were 2 percent and 5 percent of sales, respectively.

The mean initial investment in a franchised outlet in the system was $171,000, but the range was from $500 to $6 million. The average franchise fee, included in the total capital required, was $18,252. Logistic and LISREL econometric models are developed to verify the observed patterns of survival of new franchise systems.

Highlights

- Successful franchisors grow rapidly through franchising. New franchisors whose rate of system growth substantially exceeded the industry average were significantly more likely to survive.
- A minimum efficient scale must be reached quickly in order to lower costs. For example, in this study the non-survivors had outlets in 4.26 states, on average, while the survivors had outlets in 8.62 states, on average. The non-survivors had 57.3 outlets per state, while the survivors had 134.2 outlets per state.
- Successful new franchisors were 22 percent less likely to use "master franchising." Master franchising speeds system growth by providing the

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new franchisor with someone else to perform the functions of recruiting, supporting, and training franchisees for them. However, it also is more likely to be correlated with franchise system failure. The idea seems to be that master franchising involves a loss of control by the parent organization.

- Surviving new franchisors provided significantly fewer support services than non-surviving franchisors. The more the new entrepreneur is able to delegate to others things like site support, property leases, local labor problems, etc., the more likely the system is able to survive. Surviving franchisors devoted only one headquarters staff member per seven franchised outlets compared with one staff member per outlet in nonsurviving systems.
- Death rates of new franchisors were not uniform across time during the study period. Death rates were highest during the first four years, with 33 percent of franchisors disappearing during this period. This slowed to 22 percent of the original franchise systems disappearing during the next six years and ended with 19 percent dying during the last two-year interval. Therefore, the optimum period to join a new franchise system seems to be after the initial four-year period.
- Compared with other sectors, franchisors failed faster in the food industry, and particularly in food services. Between 1984 and 1987, 36.8 percent of new franchisors in the food industry failed (restaurants, grocery stores, etc.), while 27.0 percent of new franchisors in non-food retailing dissolved.
- New franchisors consider establishing credibility and a brand name vitally important in their efforts to recruit franchisees. The study found that in the critical early years of the franchise system, new franchisors were as much as 26 percent more likely to join the International Franchise Association (IFA) than were unsuccessful new franchisors. To be eligible for IFA membership, new franchisors must submit financial statements, register with each state in which they do business, and submit copies of their Uniform Franchise Offering circulars (UFOC's) Uniform Franchise Offering Circulars.
- For the period studied, the average franchise system survivor maintained a relatively stable number of company-owned outlets over time. In most cases, as the franchise system grew, the percentage of company-owned outlets declined from 22 percent to about 12 percent of the system total.
- Successful new franchisors expanded overseas. By the end of the study period, 59 percent of the surviving franchise systems had outlets outside the United States.

Conclusions

It has been estimated that, by the year 2000, 40 percent of sales in retail trade will be conducted by franchise systems. As part of its efforts to monitor the effects of these trends on the small business sector, the Office of Advocacy will continue to conduct research in this area of growing importance. As the research findings presented above indicate, due diligence is required by a small firm making a decision about whether or not to become part of a new franchise system. In most cases, these new franchise systems are not successful.

Because of the scale economies that are increasingly necessary in franchising, it is becoming more expensive for undercapitalized small firms and new entrepreneurs to succeed. Therefore, the ability to grow a franchise system quickly is a key ingredient to survival in franchising.

Keeping a lean headquarters staff is highly correlated with franchisor success. Frequently, this seems to mean that new franchisors should devote more time to building the product and its reputation, while simultaneously keeping costs low.

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