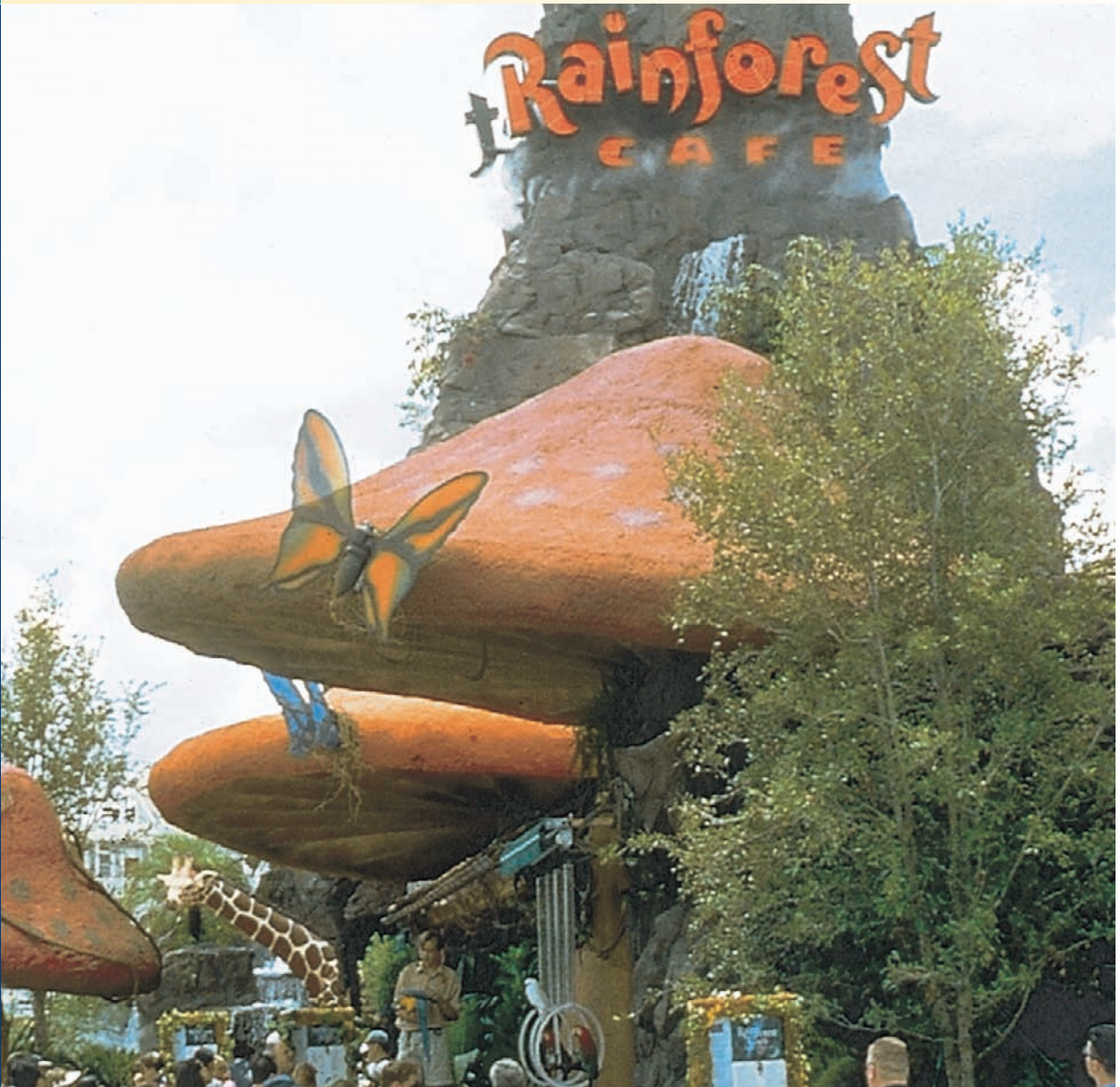


# RESTAURANT INDUSTRY ORGANIZATION: CHAIN, INDEPENDENT, OR FRANCHISE?

Courtesy of Rainforest Cafe.



## THE PURPOSE OF THIS CHAPTER

**T**his chapter is concerned with the relationship between the form of ownership of the restaurant and the likelihood of success. Chains have many advantages, but so do independents. The advantage—or disadvantage—often depends on the situation; factors such as location, type of operation, and the operation’s relationship to the community all have a bearing.

Somewhere between private ownership and chain ownership is the franchised operation. Franchisees have some of the independence of ownership but agree to give up much of it for the right to be a part of a successful concept. Because franchises play such an important role in food service, it is essential for you to assess this means of organizing ownership too.

We sometimes hear that the days of the independent restaurant are past. Although this is certainly not true, the role of the independent restaurant in the industry is changing. Chains have advantages in some industry segments, but independents have strengths that are hard to match in others. It is useful, therefore, to discuss the competitive advantages of both independents and chains. Most restaurant chains include company-owned units as well as franchised units. Franchised units have some aspects in common with chain operations and others in common with independents. For that reason, the chapter concludes with a discussion of franchised restaurant systems.

## THIS CHAPTER SHOULD HELP YOU

1. List the relative advantages and disadvantages of chains and independents in the following key areas: marketing and brand recognition; site selection; access to capital; purchasing economies; control and information systems; new product development; and human resources.
2. Identify the independent’s imperative for success; provide an example of this imperative; and identify the independent’s unique market advantage.
3. Explain the difference between product franchising and business format franchising, identify which is most commonly used in the hospitality industry, and understand the advantages and disadvantages of franchising to both the franchisor and the franchisee.

## CHAIN RESTAURANT SYSTEMS

Chains are playing a growing role in food service in North America and elsewhere in the world. In the United States, more than a quarter of all restaurants are chain-affiliated; these chains also represent about half of all restaurant revenues.<sup>1</sup> Moreover, they are prominent among the pool of companies that recruit graduates of hospitality programs and culinary programs. Both factors make them of interest to us.

Chains have strengths in seven different areas: (1) **marketing** and **brand recognition**, (2) **site selection** expertise, (3) **access to capital**, (4) **purchasing economies**, (5) centrally administered **control and information systems**, (6) new product development, and (7) human resource development. All of these strengths represent economies of scale: The savings come, in one way or another, from spreading a centralized activity over a large number of units so that each absorbs only a small portion of the cost but all have the benefit of specialized expertise or buying power when they need it.

### MARKETING AND BRAND RECOGNITION

More young children in America recognize Santa Claus than any other public figure. Ronald McDonald comes second. Because McDonald's and its franchisees spend well over \$2 billion on marketing and advertising, it's no wonder more children recognize Ronald than, say, Mickey Mouse, Donald Duck, or the Easter Bunny. Indeed, McDonald's has created a generic item—the Big Mac. The company has done for the hamburger what Coke did for cola, Avon for cosmetics, and Kodak for film. The reasons for this success are threefold: simplicity of message, enormous spending on marketing, and the additive effect. Ideally, for a company, the spending results in brand recognition.

The message of modern advertising is affected by the form in which it is offered: 10-, 30-, or 60-second television commercials, for instance. Even in the print media, the message must be kept simple, because an advertisement in a newspaper or magazine has to compete with other ads and news or feature stories for the consumer's casual attention. The message of the specialty restaurant resembles its menu. It boils down to a simple statement or a catchphrase. In fact, marketing people generally try to design a "tagline" that summarizes the benefits they want an advertising campaign to tell the consumer. Some years ago, Wendy's used the slogan "Ain't no reason to go anyplace else." Although this slogan set off a letter-writing campaign complaining about the grammar (apparently organized by high-school English teachers), Wendy's officials judged it effective in "breaking through the clutter." Of the many other advertising messages that assail the consumer, you will remember classic taglines of the past that are revived from time to time:



Many chains are synonymous with well-known brand names. (Courtesy of Darden Restaurants.)

“You deserve a break today.”

“Finger lickin’ good.”

“Pizza, Pizza.”

And, more recently:

“It’s that good.”

“When you’re here, you’re family.”

“Eatin’ good in the neighborhood.”

“Have it your way.”



A standard exterior appearance gives franchise operators and company-owned brands a high recognition value. (Courtesy of Carlson Restaurants Worldwide.)

Television advertising, even at the local level, is very expensive. To advertise regularly on national or even regional television is so expensive that it is limited to the very largest companies. Chains can pool the advertising dollars of their many units to make television affordable. Few independents, however, can afford to use television.

Independent restaurants generally spend less than chains on marketing (of all kinds, including television advertising) as a percentage of sales. Chains have a need to establish and maintain a brand name in multiple markets and to maintain a presence in the regional and national media. Furthermore, restaurants that generate a higher level of sales tend to spend a higher percentage of their revenues on marketing. Table 5.1 reflects spending on marketing, expressed as a percentage of sales, and categorized by check average. In the table, it is noticeable that the median level of marketing spending for restaurants with check averages of \$15 to \$24.99 is greater than other categories. Also, full-service restaurants spend more than limited service restaurants. This fact can

be explained by economies of scale. Quick-service company-owned and franchised chain units are fairly close to one another in spending on marketing.<sup>2</sup>

All this advertising will be effective only if consumers get exactly what they expect. Therefore, chains also concentrate on ensuring consistency of quality and service in operations. Customers know what to expect in each of the units, and in an increasingly mobile society, that is important. For those on the go, such as tourists, shoppers, or businesspeople, what is more natural than to stop at a familiar sign? If that experience is pleasant, it will reinforce the desire to return to that sign in the local market or wherever else it might appear.

**TABLE 5.1****Marketing Expenditures in Food Service****LEVEL OF MARKETING EXPENSE<sup>a</sup>**

<b>RESTAURANT TYPE</b>	<b>LOWER QUARTILE (%)</b>	<b>MEDIAN (%)</b>	<b>UPPER QUARTILE (%)</b>
<b>Full service—check average under \$15</b>			
<b>Under \$500,000 in annual sales</b>	1.1	2.5	4.6
<b>Between \$500,000 and \$999,000</b>	0.7	1.3	2.5
<b>Between \$1,000,000 and \$1,999,000</b>	0.9	1.9	3.4
<b>\$2,000,000 and over</b>	0.8	2.3	6.0
<b>Table service—check average \$15 to \$24.99</b>			
<b>Between \$500,000 and \$999,000</b>	0.7	1.6	2.9
<b>Between \$1,000,000 and \$1,999,000</b>	1.0	1.9	3.4
<b>\$2,000,000 and over</b>	0.9	1.8	2.9
<b>Table service—check average \$25 and over</b>			
<b>Between \$500,000 and \$999,000</b>	1.0	1.8	2.6
<b>Between \$1,000,000 and \$1,999,000</b>	0.8	2.0	2.7
<b>\$2,000,000 and over</b>	1.7	2.4	3.2
<b>Limited service restaurants</b>			
<b>Under \$500,000 in annual sales</b>	0.8	2.3	3.6
<b>Between \$500,000 and \$999,000</b>	1.0	2.6	5.6
<b>Between \$1,000,000 and \$1,999,000</b>	0.5	0.8	2.5

<sup>a</sup>Ratio to total sales.

Source: National Restaurant Association, "Restaurant Industry Operations Report—2008."

## SITE SELECTION EXPERTISE

The success of most restaurants is also enhanced by a location near the heart of major traffic patterns. The technique for analyzing location potential requires a special kind of knowledge, and chains can afford to staff real estate departments with people who possess this expertise. Numerous examples abound about independent restaurants not “doing their homework” when choosing a site. Although there is no exact formula that will guarantee the absolute best site, and success, chains have both experience and expertise backing them. Site selection, most experts would agree, is only getting more complex, and successful companies are becoming more sophisticated in their approach to it. To quote one industry observer: “Restaurant site selection is increasingly complicated business these days. Demographic studies, focus groups, consumer surveys, consultants, and endless number crunching are all part of the formula. No restaurateur—single shingle, multiconcept operator, or large chain—can afford to open an eatery today without spending time and money on some or all of the above.”<sup>3</sup> Sophisticated software is now available to assist operators in their decision making. Papa John’s, Krispy Kreme, and, of course, McDonald’s are all companies that are recognized for doing an admirable job of site selection.

## ACCESS TO CAPITAL

Most bankers and other lenders have traditionally treated restaurants as risky businesses, making access to capital (at least from this source) problematic. Because of this fact, an independent operator who wants to open a restaurant (or even remodel or expand an existing operation) may find it difficult to raise the needed capital. However, a banker’s willingness to lend increases with the size of the company: If one unit should falter, the banker knows that the company will want to protect its credit record. To do so, it can divert funds from successful operations to carry one in trouble until the problems can be worked out. Although franchisees are not likely to be supported financially by the franchisor, franchise companies regard a failure of one unit as a threat to the reputation of their whole franchise system and often buy up failing units rather than let them go under. In any case, failure is much less common among franchised restaurants than among independent operations. Not surprisingly, banks not only make capital available to units of larger companies and to franchised units but also offer lower interest rates on these loans.

**Publicly traded companies**, whose stocks are bought and sold on markets such as the New York Stock Exchange, can tap capital from sources including individual investors buying for their own account as well as mutual funds, insurance companies, and pension funds that invest people’s savings for them. Hospitality companies with

well-known brand names and well-established operating track records enjoy a wide following among investors, and their activity is important enough to the industry that *Nation's Restaurant News*, the popular trade magazine, carries a weekly section, "Finance," featuring a summary of approximately 100 publicly traded restaurant stocks. In addition to funds raised through stock sales, companies can sell bonds through public markets, raising larger sums than are typically available through bank loans. Among other industry leaders, Norman Brinker (Brinker International, which includes such chains as Macaroni Grill) developed a reputation for successfully taking his restaurant companies public and thus achieving his growth objectives.<sup>4</sup>

It should be noted that evidence suggests restaurant failure rates tend to be greatly exaggerated. Without publishing the commonly touted failure rates, we can say that recent research indicates that the failure rate is relatively similar to other types of businesses—somewhat lower than 60 percent over a three-year period, according to one study.<sup>5</sup>

## PURCHASING ECONOMIES

Chains can centralize their purchasing, thereby creating purchasing economies. This is accomplished either by buying centrally in their own commissary or by negotiating centrally with suppliers who then deliver the products, made according to rigid specifications, from their own warehouses and processing plants. Chains purchase in great quantity, and they can use this bargaining leverage to negotiate the best possible prices and terms. Indeed, the leverage of a large purchaser goes beyond price. McDonald's, for instance, has persuaded competing suppliers to work together on the development of new technology or to share their proprietary technology to benefit McDonald's. In addition, chains can afford their own research and development laboratories for testing products and developing new equipment.

## CONTROL AND INFORMATION SYSTEMS

Economies of scale are important when it comes to control and information systems as well. Chains can spend large sums on developing procedures for collecting and analyzing accounting and marketing information. They can devise costly computer programs and purchase or lease expensive computer equipment, again spreading the cost over a large number of operations. Daily reports often go from the unit's computerized point-of-sale (POS) system to the central office computer. There they are analyzed, problems are highlighted, and reports are sent to area supervisors as well as to the unit. This means follow-up on operating results can be handled quickly. Moreover, centrally managed inspection and quality control staff review units' efficiency and quality regularly.



## NEW PRODUCT DEVELOPMENT

The quest to create newer, better, and more interesting food products continues as competition in the restaurant industry only intensifies. Chains have the luxury of being able to staff (and finance) research and development departments that champion the development of new menu items. With adequate financial support and expertise, companies are able to test and launch new products, such as McDonald's new Angus Third Pounders, Burger King's Burger Shots 6-pack, or Pizza Hut's pasta dishes. The development of new products for restaurant companies is a combination of culinary expertise and food science expertise. Many of the chefs who head culinary development departments for restaurants are enthusiastic members of the Research Chefs Association. The association currently has over 1,000 members and is devoted to "providing the research chef with a forum for professional and educational development." Many chain organizations, including such companies such as Starbucks and Brinker International, have membership in the association. The ability to add new products to the menu mix is an important quality; new products can create positive press, increases in sales and profits, and increased **market share**.

## HUMAN RESOURCE PROGRAM DEVELOPMENT

Some restaurant chains have established sophisticated **training programs** for hourly employees, using computer-based and, increasingly, Internet-based techniques to demonstrate the proper ways of performing food service tasks and jobs. Special training exercises are also now available to subscribing companies through closed-circuit television. The standardized procedures emphasized in company training programs, in turn, lower the cost of training and improve its effectiveness. This saving is especially advantageous in semiskilled and unskilled jobs, which traditionally experience high turnover rates and, therefore, consume considerable training time. Companies that are leading the way in computer-based training include Captain D's, Sonic, and Damon's Grill. At the Cheesecake Factory, recipes are developed at the corporate office, and then the unit chefs are trained simultaneously using streaming video. Management training is also important, and large food service organizations usually can afford the cost of thorough entry-level management training programs. One food service company, for instance, estimates the costs for training a management trainee fresh out of college to be about \$20,000 over a 12- to 18-month period. This is in addition to the trainee's salary while in training, and covers fringe benefits, travel and classroom costs, and the cost of the manager's time to provide on-the-job training. In effect, this company spends as much as or more than a year of college costs on its trainees, a truly valuable education for the person who receives it.



Houston's Restaurants, a privately owned company, is well known for its development programs. (Courtesy of Houston's Restaurants.)

Because of their multiple operations, chains can instill in beginning managers an incentive to work hard by offering transfers, which involve gradual increases in responsibility and compensation. In addition, a district and regional management organization monitors each manager's progress. Early in a manager's career, he or she begins to receive performance bonuses tied to the unit's operating results. These bonuses and the success they represent are powerful motivators.

## CHAINS' MARKET SHARE

As we mentioned at the beginning of the chapter, chains have dramatically increased their market share (share of sales), representing over half of all domestic restaurant sales. This is up from less than 33 percent in the 1970s.<sup>6</sup> Of these sales, the ten fastest-growing

**TABLE 5.2****The Ten Fastest-Growing Chains with Sales over \$200 Million**

RANK	CHAIN	2008 U.S. SALES (\$ MILLIONS)	% SALES CHANGE	% UNIT CHANGE
1	Five Guys Burger and Fries	\$302	59%	49%
2	Jimmy John's Gourmet Sandwich Shop	497	29	28
3	Potbelly Sandwich Works	225	27	18
4	Noodles & Company	200	25	19
5	Wingstop	255	24	19
6	Peet's Coffee & Tea	230	23	11
7	Buffalo Wild Wings	1,229	21	14
8	Chipotle	1,275	21	19
9	Pei Wei Asian Diner	278	19	19
10	BJ's Restaurant & Brewery	377	18	20
	<b>Total</b>	<b>\$4,869</b>	<b>24%</b>	<b>22%</b>

Source: Data from Technomic Inc., Chicago.

chains (see Table 5.2) accounted for \$4.9 billion in 2008, which is some 65% of all chain sales.

Because successful chains usually have deep pockets (i.e., adequate financial reserves), they are able to ride out recessions. Indeed, some larger chains look on a recession as a time when they can purchase smaller or less successful chains that are having trouble weathering the economic storm. Although most experts agree that the concentration of chains will continue, fierce competition from regional chains (note the numerous examples used throughout this book), shifting consumer preferences, and competitive patterns will ensure that few, if any, players will establish anything resembling market dominance except on a local or temporary basis.

## INDEPENDENT RESTAURANTS

Although chains undeniably have advantages in the competitive battle for the consumer's dollar, **independent restaurants** also enjoy advantages that will ensure them a continuing place in the market—a place different from that of the chains, perhaps, but

significant nevertheless. It is also important to remember that many of the successful independent restaurants of today represent the chains of tomorrow.

## OPERATING ADVANTAGES

We can use the same method to analyze the strengths of the independents that we used to examine the chain specialty restaurants. The advantages of the chains derive basically from the large size of their organization. The advantages of the independent derive from a somewhat different common core but in many ways also claim size as their advantage. The independent's flexibility, the motivation of its owner, and the owner's presence in the operation affect its success.

In large organizations, a bureaucracy must grow up to guide decision making. Although this is a necessary—and in some ways healthy—development, it does result in a slower and more impersonal approach to problem solving in larger organizations.

In contrast, to survive and prosper, the independent must achieve differentiation: The operation must have unique characteristics in its marketplace that earn consumers' repeat patronage. Flexibility and a highly focused operation, then, are the independent's edge. Differentiation is the independent's imperative.

Although the following analysis does not deal directly with the issue, we should note that economies of scale are important in the independent restaurant also. The small operation, the mom-and-pop restaurant, finds itself increasingly pressed by rising costs. We cannot specify a minimum volume requirement for success, but National Restaurant Association figures show that in each size grouping, the restaurants with higher total sales achieve not only a higher dollar profit but a higher percentage of sales as profit.

## MARKETING AND BRAND RECOGNITION

Ronald McDonald may be a popular figure, but he is not a real person (even though he has been named Chief Happiness Officer). The successful restaurant proprietor, however, is real. In fact, successful restaurateurs often become well known, are involved in community affairs, and establish strong ties of friendship with many of their customers. You can probably think of a local restaurant operator who fits this very profile. In a sense, these operators take on celebrity status. This local "celebrity" can be especially effective in differentiating the operation in the community, generally being visible, greeting guests by name as they arrive, moving through the dining room recognizing friends and acquaintances, dealing graciously with complaints, and expressing gratitude for praise. "Thanks and come back again" has an especially pleasant ring when it comes from the boss—the owner whose status in the town isn't subject to corporate whim or sudden transfer.

Although chains may have advantages among transients, the operator of a high-quality restaurant enjoys an almost unique advantage in the local market. Moreover, word-of-mouth advertising may spread his or her reputation to an even larger area. The key to recognition for the independent is more than just personality; it is, first and foremost, quality.

Chains clearly have the advantage when it comes to advertising because of their national or regional advertising, which can create brand recognition. In contrast to chains, however, many independents spend relatively little on paid advertising, relying instead on personal relationships, their reputation, and, as noted, word of mouth. Moreover, independents begin with an advantage that chain units must work very hard to achieve: local identity.

## SITE SELECTION

The chain operation continually faces the problem of selecting the right site as it seeks new locations for expansion. It may seem that site selection would not be a problem for an independent operation because that operation is already in place. Successful independents sometimes expand by moving to a newer and larger location or by adding locations. These may be full-scale operations or, quite commonly in recent years, scaled-down versions such as the points of distribution (PODs) discussed in Chapter 3. Another occasion when independents need to make location decisions is when evolving urban patterns and real estate values change a location's attractiveness. In some cases, a neighborhood goes into decline, bringing a threatening environment that is unattractive to guests. Alternatively, a restaurant may have a lease (rather than outright ownership) in an area that has become too attractive—at least in terms of rising rents. When the lease comes up for renewal, the owner may decide to move.

When the topic of relocation or adding a location arises, however, the independent operator begins with her or his own knowledge of the area and can add to that by hiring one of the consulting firms that specialize in location analysis. This can be an expensive service, but such services are generally available and the added expense probably will be worthwhile.

## ACCESS TO CAPITAL

In most cases, chains will have the readiest access to capital. Sources of capital, however, are also available to small businesses. As noted earlier, banks are often hesitant to lend to restaurants because they are viewed as high-risk enterprises (although their willingness tends to move in cycles, just like everything else). If an operator has a well-established banking relationship and a carefully worked out business plan covering a proposed expansion, however, the local bank may be happy to make the loan.

## Working with the SBA

The key to securing an SBA loan is being prepared and finding the right lender, knowing your needs, and being able to explain how you arrived at the amount you are requesting.

A successful loan application package provides a financial history of the restaurant. It also includes a narrative background on the operation, the principal participants, and goals for the restaurant. Personal financial statements and tax returns for the owners are required. Most important are monthly cash flow projections. However, the SBA counsels that if you can obtain a conventional loan, that's what you should do. The SBA is authorized to back loans only where credit is not available on the same terms without a guarantee and only up to 85 percent. According to the National Restaurant Association, about 5,000 U.S. lenders grant SBA loans. SBA loans can take a variety of forms including the 7(a) loan. According to the SBA, "7(a) loans are the most basic and most used type loan of SBA's business loan programs. Its name comes from section 7(a) of the Small Business Act, which authorizes the Agency to provide business loans to American small businesses."<sup>1</sup>

There are certain things about the loan process you can control; the amount of preparation and how you approach a bank are two of them. The SBA recommends contacting your bank and asking what elements it requires in a loan request package. Once you have pulled together all the necessary materials, deliver the package to your banker a few days in advance of your meeting, so that there will be adequate time for him or her to review your request. That way, the banker is ready to respond to your request. Four common criteria used to determine the viability of a loan request are: previous management experience, net worth, collateral, and cash flow projections.

Whatever you, as a borrower, can bring to the table to calm the fears of the lender and show that you are well prepared to run your own business helps. That includes training, education, and experience. Knowing the business is not all it takes to be successful; you also need to have management and financial skills.

One successful borrower contacted four banks in his hunt for financing and spent nearly two years preparing his business plan. The plan included recipes, sample menus, equipment prices, and sources of supplies.

If your banker doesn't handle SBA-guaranteed loans, call the SBA district office in your area to locate banks in your state that are approved SBA lending sources. To find the district office's telephone number, consult the Small Business Administration listings under "United States Government" in the telephone book, call the SBA at (800) 8ASK-SBA, or consult its Web site ([www.sba.gov](http://www.sba.gov)).

1. Small Business Administration, [www.sba.gov](http://www.sba.gov).

The bank, however, is more likely to become involved if the operator can gain support from the U.S. **Small Business Administration (SBA)**. Participation by the SBA does not eliminate risk for the bank, but it reduces it by guaranteeing a percentage of the loan against loss. An SBA loan is likely to be for a longer period, thus lowering the monthly payments required from the borrower. Industry Practice Note 5.1 discusses how operators can gain SBA participation.

## Why Go Public?

The decision to take a restaurant company public can be a tough one for many operators. “There are really only two strong reasons for restaurant companies to go public,” says Barry M. Stouffer, a restaurant analyst for the Nashville-based investment banking and brokerage firm, J. C. Bradford. “You go public to raise capital or you go public for liquidity reasons, [meaning] you go from private to public ownership so that investors can get better valuation and can readily sell some of their interest.”

Initial public offerings did generate excitement early in the 1990s, including those of the Lone Star Steakhouse and Outback Steakhouse. Although restaurants are still going public in the current decade, getting backing from a private equity firm seems to be a more attractive option than ever before. According to Scott Pressly, a partner with Roark Capital Group, “You’re seeing larger companies go public but not seeing smaller concepts with 10 units going public. You’re seeing liquidity being provided by private equity firms. In the 1990s, restaurants went public with 10 or 20 units. You’re not seeing that today.”<sup>1</sup>

Although the decision to go public is usually predicated on the need to raise capital or to provide an exit strategy for private investors (i.e., a way to convert their ownership in a private corporation into stock that can be sold for cash if they wish to leave the business), public offerings do provide other competitive advantages for companies. Customers often feel more comfortable doing business with a public company, banks are more likely to make loans to interested franchisees, and management can add stock option plans to its arsenal of employee incentives. Yet with the additional capital come increased expectations. Some suggest that restaurants and the stock market are not good partners. In fact, some food service companies have gone public but decided to go private again—Rock Bottom Restaurant and ARAMARK, among others.

1. Jamie Popp, Scott Pressly, *All Business*, July 1, 2006. <http://www.allbusiness.com/food-beverage/restaurants-food-service-restaurants-sector/8498763-1.html>

SBA loans vary widely, from \$5,000 to \$2 million, according to the National Restaurant Association. Due to the poor economic conditions in the latter part of the last decade, the number of loans guaranteed to restaurants has declined. Still, the SBA had a budget of \$28 billion in its primary small business financing program for 2009. It should be noted, too, that some of these funds are specially earmarked for minority entrepreneurs, including those looking to enter the restaurant business.

Attracting outside equity capital involves giving up a share of ownership in the business by selling stock. Although such sales are generally limited to small chains, an independent with a concept that can form the basis of a viable chain may be a candidate for equity investment through a **venture capital** group. Industry Practice Note 5.2 discusses reasons for obtaining additional equity (i.e., ownership) capital.

Venture capital groups are made up of wealthy individuals who pool their funds under the direction of a manager with financial experience and expertise. A venture capital group will expect to have a considerable voice in the running of the business and may take a significant share of ownership in the company without necessarily increasing the value of the owner's equity in the way that a stock offering normally does. **Initial public offerings (IPOs)** involve the sale of stock through an underwriting firm of stockbrokers. An IPO would be very difficult for any but the largest independent. This method does, however, apply to successful independents that have expanded to the point where they are now small chains. Well-known restaurant companies that achieved their early expansion through IPOs include Buca di Beppo, PF Chang's, and California Pizza Kitchen. In recent years, the number of IPOs has decreased a bit with private equity firms becoming more involved in the financing of restaurant chains. In 2005, there were only three restaurant IPOs—Ruth's Chris Steak House, Caribou Coffee, and Kona Grill.<sup>7</sup> More recently, the high unemployment, cash-strapped customers, and volatile stock markets have made going public even more difficult. The silver lining is that the situation will improve as the economy renews its strength.

## PURCHASING ECONOMIES

The chain enjoys substantial advantages in its purchasing economies. The independent's problem, however, may differ somewhat from the chain's. Because of the importance of quality in the independent operation, the price advantages in centralized purchasing may not be as important as an ability to find top-quality products consistently. Thus, long-standing personal friendships with local purveyors can be an advantage for the independent.

## CONTROL AND INFORMATION SYSTEMS

Chains can use centralized cost control systems. These systems also yield a wealth of marketing information. This practice is, in fact, essential to companies operating many units in a national market. Independents are able to purchase POS systems that have standardized but highly complex software, which will generate management reports that are on a par with those available in chains. Moreover, the complex menu of the single, independent, full-service restaurant lends itself to the operator's subjective interpretation, impressions, and hunches about the changing preferences of the guests. In the end, the one difference may be in the effectiveness with which a restaurant utilizes the information provided in the reports.

Cost control procedures may be more stringent in the chain operation, but if an owner keeps an eye on everything from preparation, to portion sizes, to the garbage



can (the amount of food left on a plate is often a good clue to overportioning), effective cost control can be achieved even when a POS system to fit the operator's needs is not available or when the cost of such a system is prohibitive. By using the *Uniform System of Accounts for Restaurants*, published by the National Restaurant Association, and professional advice available from restaurant accounting specialists, independents can readily develop control systems adequate to their needs.

This description of the independent operator suggests what has become a food service axiom: Anyone who cannot operate successfully without the corporate brass looking over his or her shoulder will probably be out of business as an independent in a short time.

## HUMAN RESOURCES

The independent proprietor can, and usually does, develop close personal ties with the employees, a practice that can help reduce turnover. Even though "old hand" employees can act as trainers, the cost of training new workers tends to be higher for the independent because of the complex operation and because he or she lacks the economies of a centralized training program.

Although advancement incentives are not as abundant in independent operations as in the chains, some successful independents hire young people, train them over a period of several years to become effective supervisors, and then help them move on to a larger operation. Often, too, the independent finds key employees whose life goals are satisfied by their positions as chef, host or hostess, or head bartender. These employees may receive bonus plans similar to those offered by the chains.

Independents have a special attraction for employees who are tied by family obligations or a strong personal preference to their home community. The problem of being transferred is unlikely to arise with independents. With chains, however, the probability is that advancement is dependent on a willingness to relocate.

## THE INDEPENDENT'S EXTRA: FLEXIBILITY

Perhaps the key that independents can boast of is the flexibility inherent in having only one boss or a small partnership. Fast decision making permits the independent to adapt to changing market conditions. In addition, because there is no need to maintain a standard chain image, an independent is free to develop menus that take advantage of local tastes. Local restaurants can also easily incorporate local products, which makes for a sustainable operation that also supports the local economy. Finally, there are many one-of-a-kind niches in the marketplace, special situations that don't repeat themselves often enough to make them interesting to chains. Yet these situations may be ideally suited to the strengths of independents.

Mimi's Cafe was privately owned and grew to the point of being acquired by Bob Evans. (Courtesy of Mimi's Cafe.)



## THE INDEPENDENT'S IMPERATIVE: DIFFERENTIATION

One element of the independent's differentiation, as we have seen, is the personal identity of its owner, and another is its reputation as a local firm. Strategically, it is important to choose a concept—that is, a menu, service style, ambience, and atmosphere—that is fundamentally different from what everybody else is doing. Ninety percent of hamburger sandwich sales are made by the major chains. Logically, then, the quick-service hamburger market (or fried chicken, etc.) is not one for an independent operator unless it has a unique advantage. There is a good chance that KFC's brand appeal will be more powerful than any product differentiation an independent can achieve in a fried chicken take-out unit. Instead, independents must present a menu and dining experience that is uniquely their own. Independents rely on the differentiation provided by unique foods, outstanding service, pleasing ambience, and personal identity to achieve clear differentiation and consumer preference.

## BETWEEN INDEPENDENT AND CHAIN\*

Between the independent and the chain lie at least two other possibilities. Some independent operations are so successful that they open additional units—without, however, becoming so large as to lose the hands-on management of the owner/operator.

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\*The authors would like to acknowledge the assistance and guidance of Udo Schlenrich in the development of this section. Professor Schlenrich is Associate Professor in the Department of Hospitality Management at the University of New Hampshire and director of the William Rosenberg Center of International Franchising.



Another busy night at one of the newest Tutta Bella Neapolitan Pizzerias. (Courtesy of Tutta Bella.)

*Nation's Restaurant News* refers to these as independent group operators. They are not exactly chains but, because of their success, they are no longer single-unit operators. Some examples include Richard Melman's Chicago-based "Lettuce Entertain You," Drew Nieporent's New York-based Myriad Group, Danny Meyer's New York-based Union Square Hospitality Group, and Wolfgang Puck's restaurants. All of these concepts started as a single neighborhood restaurant. Some, such as Lettuce Entertain You, operate many different concepts, but each is few in number. Operating dissimilar concepts under a single umbrella has been a successful business format for these operators.

A regional example of this is Tutta Bella Neapolitan Pizzerias, located in the Pacific Northwest. In 2009, the concept was selected as one of the five Hot Concept awards at the Nation's Restaurant News' 50th annual Multi-Unit Foodservice Operators conference. In addition, *Restaurants & Institutions* named Tutta Bella's seasonal summer pizza as one of the most innovative menu items.

Another operating possibility, and one that is pursued by thousands of businesspeople, is a franchised operation, which is discussed next.

## FRANCHISED RESTAURANTS

Franchising has become a common business format. According to a study by the Educational Foundation of the International Franchise Association, it is estimated that through the decade franchises will generate over 45 percent of all retail revenues in the United States.<sup>8</sup> Franchising also generates over 18.1 million jobs in the United States, which represents 13.7 percent of direct and indirect private sector employment. Franchises also earn \$1.53 trillion annually, representing 9.5 percent of America's total private sector output. As a point of reference, franchised businesses generate about the same number of jobs in the United States as do the manufacturers of durable goods. In addition, franchised establishments represent the greatest percentage of all line-of-business establishments in quick-service restaurants, lodging, and retail food.

A conversation with a franchisee is likely to yield this contradiction: The franchisee clearly thinks of him- or herself as an independent businessperson but is likely to refer to the franchisor in the course of the conversation as "the parent company." To some, franchises offer the best of both worlds. As William Rosenberg, founder of Dunkin' Donuts, said, franchising allows one to be "in business for yourself, but not by yourself."<sup>9</sup>

Many people automatically think "restaurant" when they hear the word franchising. This is not surprising, since roughly one-half of restaurant sales in the United States are made by franchised units. Quick-service restaurants featuring hamburgers make up the largest category of franchised units. Pizza, steak, full-menu operations, and restaurants featuring chicken also constitute a large number of franchised operations.

There are two basic kinds of franchising: product or trade name franchising and **business format franchising**. Trade name franchising, such as a soft drink or automobile dealership, confer the right to use a brand name and to sell a particular product.

The type of franchising found in the hospitality industry, however, is called business format franchising. Business format franchising includes use of the product (and service) along with access to, and use of, all other systems and standards associated with the business.

The franchisee has a substantial investment (ownership of the franchise and very possibly of land, building, furniture, and fixtures or a lease on them). Beyond that, he or she has full day-to-day operating control and responsibility. For instance, franchisees are

responsible for hiring employees, supervising the daily operation (or managing those who do that supervision), and generally representing themselves in the community as independent businesspeople. The degree of franchisee control over key issues varies from one franchise group to another, but many franchisees share considerable freedom of advertising, choice of some suppliers, and the ability to add to and renovate the physical plant. Although some aspects of the unit's budget are governed by the **franchise agreement**, the franchisee retains significant budgetary discretion under most agreements and in practice exercises even more.

The essence of almost all franchises in the hospitality industry is an agreement by the franchisee to follow the form of the franchisor's business system in order to gain the advantages of that business format. The franchisee has, indeed, relinquished a great deal of discretion in the management of the enterprise and is a part of a system that largely defines its operation. The restaurant franchisee's relationship is neither that of an employee nor that of an independent customer of the franchisor.

The most common characteristics of a franchise agreement include:

- Use of trademarks
- Location of the franchise
- Term of the franchise
- Franchisee's fees and other payments
- Obligations and duties of the franchisor
- Obligations and duties of the franchisee
- Restrictions on goods and services offered
- Renewal, termination, and transfer of franchise agreement<sup>10</sup>

Additional topics that may be included are operating procedures and advertising and promotion. Other services that may be provided by the franchisor on a fee basis (such as training or accounting services) are also included.

## THE NEW FRANCHISEE

The franchisor offers to an investor, who often has no previous experience, a proven way of doing business, including established products, an operating system, and a complete marketing program.

A well-developed franchise minimizes risk, but this may not be true of a new, unproven franchise concept. Moreover, a franchise cannot guarantee a profit commensurate with the investment made—nor even guarantee any profit at all. SBA studies indicate that somewhere between one-quarter and one-third of all businesses fail during their first year, and 65 percent fail within their first five years.<sup>11</sup> The International

Franchise Association estimates failure rates among franchised quick-service restaurants at 19 percent and just over 11 percent for other types of restaurants.<sup>12</sup>

In addition to an overall concept, the franchisor provides a number of specific services to the newcomer. Next we discuss the most common of these services.

**SCREENING.** Being screened to see whether you are an acceptable franchisee may not seem like a service. A moment's reflection, however, will show that careful franchisee selection is in the best interest not only of the company and other, existing franchisees but of the prospective franchisee as well.

**FINANCING.** Because franchising minimizes the risk of business failure, potential franchisees are generally able to obtain financing for established franchise concepts more readily than entrepreneurs who want to launch an independent business concept. This applies especially to the financing of hotels and restaurants, which are particularly high-risk ventures. In addition, some franchisors offer direct financial assistance through formal financing programs.

**SITE SELECTION AND PLANNING.** Franchisors maintain a real estate department staffed with site selection experts. The franchise company also has its pooled experience to guide it. Given the importance of location to most hospitality operations, the availability of expert advice is important. The physical layout of the operation, from the site plan to the building, equipment, and furnishings, and even a list of small wares (e.g., ladles and spatulas) and opening inventory, will be spelled out in detail.

**PREOPENING TRAINING.** Virtually all franchise organizations have some means of training the franchisee and his or her key personnel. This service ranges from McDonald's Hamburger University to simpler programs based on experience in an existing store.

**OPERATIONS MANUALS.** The backbone of the operating system is typically a set of comprehensive operations manuals and a complete set of recipes that cover all products on the menu. The operations manual sets forth operating procedures from opening to closing and nearly everything in between. All major equipment operations and routine maintenance are described in the operations manual or in a separate equipment manual. Industry Practice Note 5.3 outlines questions a prospective franchisee should keep in mind when assessing a franchisor.

## CONTINUING FRANCHISE SERVICES

Once a unit is open and running, the first year or two of advice and assistance are the most crucial. Even once a franchisee is sufficiently experienced to manage his or her

unit without close assistance, the advantages of a franchise are still impressive. These services relate to operations and control and to marketing.

**OPERATING AND CONTROL PROCEDURES.** The franchisor strives to present operating methods that have control procedures designed into them. For instance, McDonald's not only specifies the portion sizes of its french fries but also has designed packages and serving devices to ensure that the portion sizes will be accurately maintained. Similarly, Long John Silver's specifies a procedure for portioning fish to minimize waste.

The essential ingredient in a successful franchisor's proven way of doing business is not just a great idea but an operational concept. The concept works and is accepted by customers, and its results can be tracked so that its continuing success can be measured and assessed. We should note here, too, that the product and service that underlie the franchise must be redeveloped continually to remain current in the marketplace. Franchisor services in several specialized areas related to operations and control are discussed next.

**INFORMATION MANAGEMENT.** Accounting systems furnished by franchisors normally integrate the individual sales transactions from the POS terminal with both daily management reports and the franchisee's books of account. This makes current management and marketing information available in a timely way and helps hold down the cost of accounting services. This system also provides the franchisor with reliable figures on which to compute the franchisee's royalty payments and other charges such as the advertising assessment.

**QUALITY CONTROL.** Inspection systems help keep units on their toes and provide the franchisee with an expert—if sometimes annoying—outsider's view of the operation. Quality control staff use detailed inspection forms that ensure systemwide standards. Inspectors are trained by the franchisor, and their work is generally backed up by detailed written guidelines.

**TRAINING.** In addition to the opening training effort, franchisors prepare training materials such as videotapes and CD-ROMs that cover standardized ways of accomplishing common tasks in a unit. The franchisor's training department also prepares training manuals and other training aids.

**FIELD SUPPORT.** There is general agreement on the importance of field support and how it ultimately can determine the quality of the company. Further, the backbone of field support is an experienced franchise district manager. One of the most serious problems with unsuccessful franchise systems is a lack of field staff or field staff lacking in expertise.

## Interested in Becoming a Franchisee?

Here are seven basic questions for a prospective franchisee:

1. Is the company itself reasonably secure financially, or is it selling franchises to get cash to cover ongoing expenses?
  - Is the company selective in choosing franchisees?
  - Is it in too big a hurry to get your money? Is this deal too good to be true? Today, sweetheart deals are few and far between.
2. Does the company have a solid base of company-owned units? If it does:
  - Is the company in the same business as its franchisees?
  - Does the company concentrate on improving marketing and operating systems?

If your primary business is operations and the company is selling franchises, the system is headed for trouble.

3. Is the system successful on a per-unit basis? To find out, look at several numbers:
  - Comparable average sales of stores that have been open longer than one year (sometimes first-year sales are very high and then drop off).
  - Unit-level trends: What is really needed are sales data adjusted for inflation or, better yet, customer counts at the unit level.

A business is really only growing when it's serving more people.

4. Is the franchisor innovative across all parts of its business?
  - The company should be working on operating and equipment refinements.
  - Ask what it is doing in purchasing, recruiting, training, and labor scheduling. Is anyone working to make uniforms more attractive, durable, and comfortable, for instance?

The best companies are consistently trying to upgrade every component of their business.

5. Does the company share sufficient support services with its franchisees?
  - In general, the company should provide guidance and strategic direction on marketing and excellent operations training. In addition, every franchisee should have contact with a company employee whose primary responsibility is a small group of franchised restaurants.
  - There are some services that a company can't provide, such as setting prices. In addition, others are risky, such as getting involved in franchisee manager selection.

Support services must be shared in such a way that they respect the franchisee's independence.

6. Does the company respect its franchisees?
  - In addition to formal publications, there should be regular informal forums or councils in which selected franchisees meet face-to-face with top management to discuss both problems and opportunities.

*Continues on next page*



## Interested in Becoming a Franchisee?

*Continues from previous page*

- Corporate staff should collect ideas, test them, and, if they look good, involve franchisees in expanded testing.

Franchisees should actually participate in the development of any change that will affect their units.

7. Does the franchisor provide long-term leadership for the entire system?

- Franchisee participation is no excuse for the franchisor's abdication of its leadership responsibilities. Somebody has to make the formal decisions, and that must be the franchisor.
- A primary function of the franchisor is to protect the value of each franchise by actively and aggressively monitoring operations, demanding that each unit live up to system standards.

Perhaps a necessary long-term decision is not popular. Making tough decisions and following through may be the best real test of leadership.

Source: Adapted from Don N. Smith, Burtenshaw Lecture, Washington State University, 1985

**PURCHASING.** Most franchised restaurant companies have purchasing cooperatives. The co-op offers one-stop shopping for virtually all products required in the operation: food, packaging, and equipment, and, often, insurance programs. In addition, the co-op periodically publishes a price list that the units can use in negotiating prices with local distributors. The co-op may also publish a newsletter containing information on pricing and trends in equipment, food products, and supply.

Although attractive price and the convenience of one-stop shopping are important franchisee purchasing benefits, particularly with the co-ops, perhaps the most important advantage in the purchasing area is quality maintenance. The lengthy product development process includes careful attention to each product ingredient and the development of detailed product specifications. Often the franchisor will work with the research department of a supplier's company to develop a product to meet these specifications and to anticipate market fluctuations. Moreover, it is common for franchisors to maintain quality control staff in a supplier's plants and institute rigorous inspection systems that monitor the product from the fabrication plant to regional storage centers and then to the individual operating unit.

**MARKETING.** Second only in importance to providing franchisees with a unique way of doing business is provision of a well-established brand and the ongoing development and execution of the system's marketing plan. Although franchisees usually are

consulted about the marketing program, the executive responsibility for developing and implementing the system's marketing program lies with the franchisor's top management and marketing staff.

**ADVERTISING.** In addition to developing and executing a national or (for smaller chains) regional advertising program, most franchisors assist in operating advertising co-ops that are funded with franchisees' advertising contributions. National advertising co-ops typically provide copies of the company's television and radio commercials to franchisee members for a nominal price as well as templates for both black-and-white and color newspaper ads. Co-ops also develop point-of-purchase promotional materials, such as window banners and counter cards. Regional and local co-ops devote their efforts to media buying and to executing the advertising program in their area. The pooling of media buys at the local level yields substantial savings, makes advertising dollars go further, and secures a frequency of advertising that heightens effectiveness. Local and regional co-ops also often coordinate local promotional programs, such as those using coupons, games, or premium merchandise.

**NEW PRODUCTS.** The marketplace changes constantly, and it is the franchisor's responsibility to monitor and respond to those changes. The company's marketing department carries out a program of continuing market research. When a new product emerges, from research or from suggestions from franchisees, the company develops the new product in its test kitchens and tests it for consumer acceptance with taste panels and for fit with the operating system in a pilot store or stores. If test marketing in selected units is successful, the product will be rolled out systemwide with standard procedures for operation and extensive promotional support.

**NEW CONCEPTS.** Some franchisors have developed or acquired entirely new concepts. Sometimes this effort is undertaken to offer existing franchisees opportunities for new store growth without moving outside the franchisor's system. Increasingly, however, new concepts are used to build volume in an existing store much the same way as adding a new product to the menu. These major changes in the franchisor and franchisee's product line are achieved through co-location of two or more concepts (known as **co-branding** or dual branding). Wendy's, for instance, acquired a coffee and doughnut chain, Tim Horton's, clearly a noncompetitive product line for Wendy's main brand. (At the time of this writing, Wendy's is in the process of selling it off as a separate public company.)

The Tim Horton's menu draws many customers in the morning, when the Wendy's menu isn't even offered. The concepts work synergistically. By each occupying half the space, Wendy's and Tim Horton's save about 25 percent on building and site costs at each shared site. In some locations, Tim Horton's products are offered at a kiosk adjacent to the Wendy's operation. Although the saving on site costs is important, the

greatest benefit is incremental sales. These are achieved, first of all, through the new concept. Equally important, however, is the exposure. In the preceding example, Tim Horton's breakfast customers are exposed to a Wendy's as a possible lunch site and, of course, lets Wendy's lunch and dinner customers know where they can get a quick breakfast. The dual branding of Miami Subs and Baskin-Robbins represents a similarly beneficial arrangement. The concept of dual branding has recently taken another step forward with some companies offering multiple brands in one location. The grouping of Dunkin' Donuts, Baskin-Robbins, and Togo's is an example. The grouping of multiple concepts creates more choice for customers as well as greater profit potential for the company.

Dual branding is not the only strategy that companies use to boost revenues. Some restaurant companies, such as CKE (Carl's Jr. and Hardee's) and Yum! Brands (KFC, Taco Bell, Pizza Hut, Long John Silver's, and A&W) offer food products from other companies (or from other restaurants within the same group).

## THE FRANCHISEE'S VIEW

Some of the more obvious drawbacks of obtaining a franchise have been implicit in our discussion: loss of independence and payment of substantial advertising assessments and franchise fees. If the franchisee has picked a weak franchising organization, field support and other management services may be inadequate and could result in underperformance or failure of the franchise unit. There are numerous factors to consider, as outlined in the sections that follow.

**ADVANTAGES TO FRANCHISEES.** The primary advantages of franchising from the perspective of the franchisee are the provision of a recognizable brand, attested and refined product and service concepts, technical assistance in the areas of site selection, construction, interior design, training, marketing, and ongoing operational support. In addition, franchisors often assist franchise applicants in obtaining financing and/or lease agreements.

The U.S. Trade Commission has issued extensive regulations in order to protect potential franchisees from misrepresentation by franchisors. These regulations are contained in a document called the Uniform Franchise Offering Circular (UFOC). UFOCs include 23 important disclosure statements, such as details about a franchisor's business experience, its key employees, its litigation history, fees and investment requirements, franchisee and franchisor obligations, territorial rights, trademark regulations, and renewal and termination terms. Inaccuracies or misrepresentations by franchisors in their UFOC can result in civil or criminal penalties. There are also ranking of franchises that are the result of franchisee input. One of these is the Franchisee Satisfaction Awards. In the food category in 2009, several foodservice chains were highly ranked including Auntie Anne's Pretzels, Bruegger's, Great Wraps! and Simple Simon's Pizza.<sup>13</sup>



Expansion is an important activity for franchise companies. (Courtesy of Domino's Pizza, Inc.)

**FRANCHISING IS NOT RISK-FREE: DISADVANTAGES TO FRANCHISEES.** The franchisee is generally completely dependent on the franchisor not only for marketing but often for purchasing and other operations-oriented assistance. If a franchise concept is not kept up-to-date—as many argue was the case some years ago for Howard Johnson's restaurants, for instance—or loses its focus, it is difficult for the franchisee to do much about it.

What happens when things really go wrong is illustrated by the case of Arthur Treacher's Fish and Chips. A successful and growing franchise in the mid-1970s, Treacher's then had serious difficulties that ended in bankruptcy. Its national marketing efforts virtually ceased. Its product quality control system broke down, yet the franchisees were contractually obligated to purchase only from approved suppliers. The franchisees also were required to pay both advertising fees and royalties but claimed they received few or no services in return. Many franchisees withheld payment of fees and royalties and then became involved in lengthy lawsuits that were expensive in both executive time and

attorney's fees. Although some Treacher's franchisees weathered the series of setbacks, virtually all suffered serious losses, and many left the restaurant field. Although the Treacher's franchise system has begun to grow again, the turnaround took a number of years.

Franchisors normally charge franchisees a one-time initial fee when a contract is signed. For quick-service franchises, the initial fee normally ranges from \$10,000 to \$75,000, with a median fee of \$25,000. In addition, franchisors charge an ongoing advertising fee and a royalty fee (which covers the use of the brand trademark, the operational systems, and marketing support). Advertising and royalty fees are based on a percentage of gross sales, with the percentage varying from system to system. For quick-service franchises, the average royalty fee is about 5 percent and the average advertising fee is about 2 percent.<sup>14</sup>

## THE FRANCHISOR'S VIEW

**ADVANTAGES TO FRANCHISORS.** The franchisee makes most—often, all—of the investment in a new unit. As a result, franchising gives the franchisor the means to expand rapidly without extensive use of its own capital. By expanding rapidly, the franchising organization achieves a presence in the marketplace that is, in itself, an advantage. Moreover, the more units a company has in a market, the more advertising media it can afford to buy. In addition, the better the geographic coverage, the easier it will be for people to visit often; the restaurants are simply closer and more convenient. Finally, continuous exposure of all kinds—seeing television commercials, driving past the sign and building, as well as actually visiting the restaurant—contribute to “top-of-mind awareness,” that is, being the first place that comes into people's minds when they think of a restaurant. Being in place in a market is a crucial advantage and one more readily secured quickly through franchising.

The franchising organization also gains highly motivated owners/managers who require less field supervision than company-owned units do. A district manager supervising owned units is usually responsible for four to eight units. A supervisor (or franchise consultant, as they are sometimes called) overseeing franchised units is likely to cover somewhere between 15 and 30 units. (This number has been increasing gradually over the last several years as companies have reorganized and tried to improve communications between the field and the home office.) This permits a large company, such as McDonald's, to operate with a much smaller organization than would be possible if it had to provide close supervision to all of its thousands of units.

Franchising companies also draw on franchisees as a source of know-how. Numerous examples exist where franchisees have come up with a better way for the company to do things or have come up with new products that made sense for the company to

## Rosenberg International Center of Franchising

The Rosenberg International Center of Franchising (RICF) was created according to the vision of William Rosenberg, a franchising pioneer and the founder of Dunkin' Donuts. Mr. Rosenberg saw the need for a specialized center that would advance the field of franchising through relevant research and innovative teaching. Educational and research guidance is provided by a top-level advisory board representing the various segments of the franchise community. The mission of RICF is:

- To produce a broad range of franchise-related research that addresses issues of present and potential future interest
- To educate students and entrepreneurs about franchising and business issues relevant to the franchise community
- To stage periodic international symposia allowing for the interaction of academic and business leaders in the field of franchising

The center's research focuses on the analysis of the financial performance of franchise companies, both in the United States and internationally. The center publishes a quarterly *Franchise 50 Index* that tracks the performance of the top 50 publicly listed U.S.-based franchise companies against that of the Standard & Poor's (S&P) 500. In addition, the center publishes articles that highlight current issues of interest to the academic, franchise, and financial communities. Key topics include international expansion strategies, risk and opportunity assessment, and valuation of franchise companies. In addition, the Center maintains the world's most extensive Web-based Franchise Bibliography & Database in cooperation with EBSCO Information Systems.

The center teaches a franchise course at the Whittemore School of Business and Economics and hosts franchise-specific seminars to senior executives from the hospitality industry. In addition, guest lectures are offered at select universities in the United States and abroad. Franchise case studies are written by the center's faculty in order to bring the complexity of real business world issues into the classroom.

RICF maintains a close relationship with the International Franchise Association, the largest representative body of franchisors and franchisees in the world, and its Educational Foundation. The center is also actively involved in advising individuals who are interested in acquiring a franchise or starting their own franchise system.

offer systemwide. Some of these examples include the Egg McMuffin (McDonald's) and the gun that Taco Bell uses to dispense sour cream.

**DISADVANTAGES TO FRANCHISORS.** The bargain struck with franchisees has its costs to franchisors. Although their experience varies, many franchise companies find that their owned stores yield higher sales and profit margins. In addition, if the company

owned all its units—if it could overcome the organizational difficulties of a much larger, more complex organization—the profits earned from the same stores would be higher than the royalties received from a franchised store.

From time to time, franchising companies are struck by the amount of profit they are giving up. In the late 1980s and early 1990s, PepsiCo embarked on an ambitious repurchase program in its restaurant divisions, then made up of KFC, Taco Bell, and Pizza Hut. The effect, however, was to tie up a lot of capital without improving returns enough to justify the investment. PepsiCo and then Yum! Brands (the company that now owns KFC, Taco Bell, and Pizza Hut) and others have more recently followed an aggressive program of refranchising the units they purchased earlier.

We should note that not all franchise royalty income is profit. Usually, 2 percent of sales is needed to service a franchise system. Because of start-up costs for a new franchised unit for the franchisor, it may be three years before the royalties begin to contribute to the franchisor's profit. In addition, the franchisor will already have made a considerable investment in legal and accounting costs as well as executives' time.

## FRANCHISOR-FRANCHISEE RELATIONS

We have said that franchisees are independent in some ways and yet subordinate in other ways. It is hardly surprising that this somewhat contradictory relationship sometimes leads to problems. To secure better communication between the parties, most franchisors have a franchisee council—KFC, for example, calls it a Service Council—made up of representatives elected by the franchisees. This council meets with the franchisor's top management to discuss major marketing and operational issues.

## FRANCHISING: A MIDDLE WAY

The franchisee is not fully independent, but neither is he or she as much at risk as the independent. Taking part in a larger organization that provides vital services while still allowing a considerable measure of financial and managerial independence has much to say for it. A person who is unable to work within a tightly prescribed system would be uncomfortable as a franchisee. Those who can live within such a framework, however, can reap significant rewards with less risk than they would have in their own business.

Franchising is receiving more attention both from industry and academia. Industry Practice Note 5.4 describes the work of the William Rosenberg Center of International Franchising at the University of New Hampshire and the various services it provides to the franchising community.

## SUMMARY

Restaurants are organized into groups in chains or franchise organizations or stand alone as independents. Chains and independents can be compared on the basis of brand recognition, site selection, access to capital, purchasing economies, information and control systems, and human resource programs. The strengths of chains come largely from economies of scale. The independent's advantages lie in flexibility and the closeness of the owner/manager to the operation. To be successful, however, independents must differentiate their operation so that they stand out from the crowd.

Franchising offers operators a degree of independence but requires a willingness to work within a defined operation. Franchisees must give up some control over the operation, but in return their risks are lowered dramatically. Franchisees generally pay a development fee, a royalty fee, and an advertising assessment. The franchisor provides a proven system of operation and expert field staff as well as a marketing program.

Services that are especially helpful to new franchisees include screening, site selection and planning, preopening training, and complete documentation of the operating concept in an operations manual. The chapter identifies ten areas of support to continuing franchisees: operating and control procedures, information management, quality control, training, field support, purchasing, marketing, advertising, new products, and new concepts.

There are positive and negative aspects of franchising for both partners in the arrangement. Franchisees gain a proven format and the assistance described previously but give up much of their independence and are required to pay substantial fees. Moreover, the franchisee is completely dependent on the franchisor. The franchisor can expand rapidly, largely on the franchisee's investment and organization, and has in the franchisee a highly motivated manager and a rich source of innovative ideas. However, company stores—those operated by the franchisor—often yield higher sales and better profits, which the franchisor must give up along with a significant degree of operational control. Given the close and somewhat ambiguous nature of their relationship—neither that of employee and employer nor that of independent partners—there is often conflict within the franchise community, which franchisors are moving to contain with franchisee councils.

### Key Words and Concepts

**Marketing**  
**Brand recognition**  
**Site selection**  
**Access to capital**

**Purchasing economies**  
**Control and information system**  
**Publicly traded companies**  
**Market share**



**Training programs**  
**Independent restaurants**  
**Small Business**  
**Administration (SBA)**  
**Venture capital**

**Business format franchising**  
**Initial public offering (IPO)**  
**Franchise agreement**  
**Co-branding**

## Review Questions

1. How do you rate the advantages of the chain (and independent) on the seven factors cited in the text? Are there other factors that should be considered?
2. What is the trend in market share of chains in food service? Explain this trend.
3. What are the major services provided by the franchisor to the new franchisee? Contrast them with the continuing services provided to established franchisees.
4. How do you assess your prospects as a franchisee? What characteristics do you think would be important to being a successful franchisee?
5. What does the franchisor gain from franchising? What advantages does the franchisor give up by franchising instead of owning units?

## Internet Exercises

1. **Site name:** William Rosenberg Center of International Franchising

**URL:** [wsbe.unh.edu/centers\\_wrcif/home.cfm](http://wsbe.unh.edu/centers_wrcif/home.cfm)

**Background information:** The William Rosenberg International Center of Franchising was created according to the vision of William Rosenberg, a franchising pioneer and founder of Dunkin' Donuts. Mr. Rosenberg saw the need for a specialized center that would advance the field of franchising through relevant research and innovative teaching. His generous grant to the University of New Hampshire along with his vision and drive provided the foundation upon which the center was launched in the fall of 2002.

**Exercises:**

- a. Analyze the entire Web site, and describe the resources available to a potential franchisee.
- b. Examine several stock market quarters listed on the *Franchise 50 Index* page. Which hospitality companies are identified as gaining or losing for the quarter being reviewed?

- c. What might account for the increase or decrease of the stock of a publicly traded restaurant chain in any given three-month period?

**2. Site name:** International Franchise Association

**URL:** [www.franchise.org](http://www.franchise.org)

**Background information:** The International Franchise Association (IFA), founded in 1960, is a membership organization of franchisors, franchisees, and suppliers. Its Web site is dedicated to providing members and guests with a one-stop shopping experience for franchise information.

**Exercises:**

- a. Analyze the entire Web site, and list and describe the resources available to assist the potential franchisee. Include both information that is free to the general public and courses that are available through the IFA-University for a fee.
- b. On the Web site, choose a food-related franchise that is available in your state. Identify the following for that franchise: when the business was first established, when it began franchising, the number of units that are currently franchised, the number of company-owned units, estimated start-up costs, total investment needed, training provided, and the qualifications of the potential franchisee.

**3. Site name:** Small Business Administration

**URL:** [www.sba.gov](http://www.sba.gov)

**Background information:** The U.S. Small Business Administration (SBA) was created by Congress in 1953 to help America's entrepreneurs form successful small enterprises. Today, SBA's program offices in every state offer financing, training, and advocacy for small firms. These programs are delivered by SBA offices in every state, the District of Columbia, the Virgin Islands, and Puerto Rico. In addition, the SBA works with thousands of lending, educational, and training institutions nationwide.

**Exercises:**

- a. Surf the SBA Web site and identify the programs provided by the SBA for entrepreneurs who wish to start their own business.
- b. Describe in detail three SBA programs that may be helpful to you, if you were starting your own business.
- c. You want to start your own restaurant but need financing in order to start. Describe in detail what the SBA can do to help you obtain financing.
- d. The SBA provides over 65 online training courses for the aspiring entrepreneur. Lead a class discussion on the categories of training provided by the SBA, and discuss some of the courses you think would be most beneficial.

- e. The SBA hosts seminars nationwide that would assist an individual who wishes to start his or her own business. Click on your state, and identify the workshops that are being offered in your area.
  - f. Identify the elements of a model business plan, and write a sentence or two describing the information required for each element.
  - g. The SBA provides information on managing your new enterprise. Describe the leadership traits it considers important for an entrepreneur to be effective.
  - h. Discuss how the SBA supports women and minorities.
  - i. Describe the information the SBA provides on franchising.
  - j. Review an example of a restaurant, food service, bar, or nightclub business plan. Lead a class discussion on how effectively the author addressed all of the elements of a model business plan.
- 4. Site name:** Top 100 Restaurant Chains  
**URL:** [http://www.technomic.com/Resources/Industry\\_Facts/dynTop\\_100.php](http://www.technomic.com/Resources/Industry_Facts/dynTop_100.php)  
**Background information:** This site lists the top chain restaurants and is updated each year. It includes changes in sales from the prior year.  
**Exercises:**
- a. Explore Web sites from three independent restaurant sites in your area and three chain restaurant sites from the “Top 100” list. Describe the differences and similarities among the independent and the chain groups.
  - b. After reviewing their Web sites, is there a significant difference between the “look and feel” of the chain Web sites and the independent operator’s Web sites?
- 5. Site name:** *National Restaurant Association*  
**URL:** <http://www.restaurant.org/pdfs>  
**Background information:** The National Restaurant Association has been the industry’s leading association since 1919.  
**Exercises:**
- a. Click on the link to the latest industry fact sheet. Do you find any reason to believe chains are growing more than independents?
  - b. Click on the *research* tab. From the information on the site, what changes do you anticipate we will see in the industry?

## Notes

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