

Entrepreneurial Management

Chapter 4

Franchises and Buyouts

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*After studying this chapter,
you should be able to...*

1. Define *franchise*, and become familiar with franchise terminology.
2. Understand the pros and cons of franchising and the structure of the industry.
3. Describe the process for evaluating a franchise opportunity.
4. List four reasons for buying an existing business, and describe the process for evaluating an existing business.



What Is a Franchise?

- **Franchising**

- A business model involving a business owner who licenses trademarks and methods to an independent entrepreneur.

- **Franchisor**

- Party in franchise contract that specifies methods to be followed and terms to be met by the other party.

- **Franchisee**

- An entrepreneur whose power is limited by a contractual agreement with a franchising organization.

Franchising Defined

In simple terms, franchising means getting the right to operate a business from the franchisor for a fixed price, which includes the usage of the trademark and the business model. The interested party is the franchisee and the owner of the business is the franchisor.

Franchising is bound by various legal documents and considerations to secure smooth business operations. The Franchise Agreement (FA) document is the paper that specifies all the duties of the franchisor and the franchisee, duration, and the provisions. Take note that it is essential before starting out any business-related operations between you and the franchisor.

Franchising Defined

FA is set on a renewal basis and that makes the franchising deal temporary. However, despite that, it is essential that you know the terms and provisions that govern your agreement with the franchisor.

Franchising in the Philippines is both technical and easy to understand if you manage to familiarize [franchising basics and its interesting facts](#). Hence, aside from the fees and others, pay attention to their business models and observe how it works.

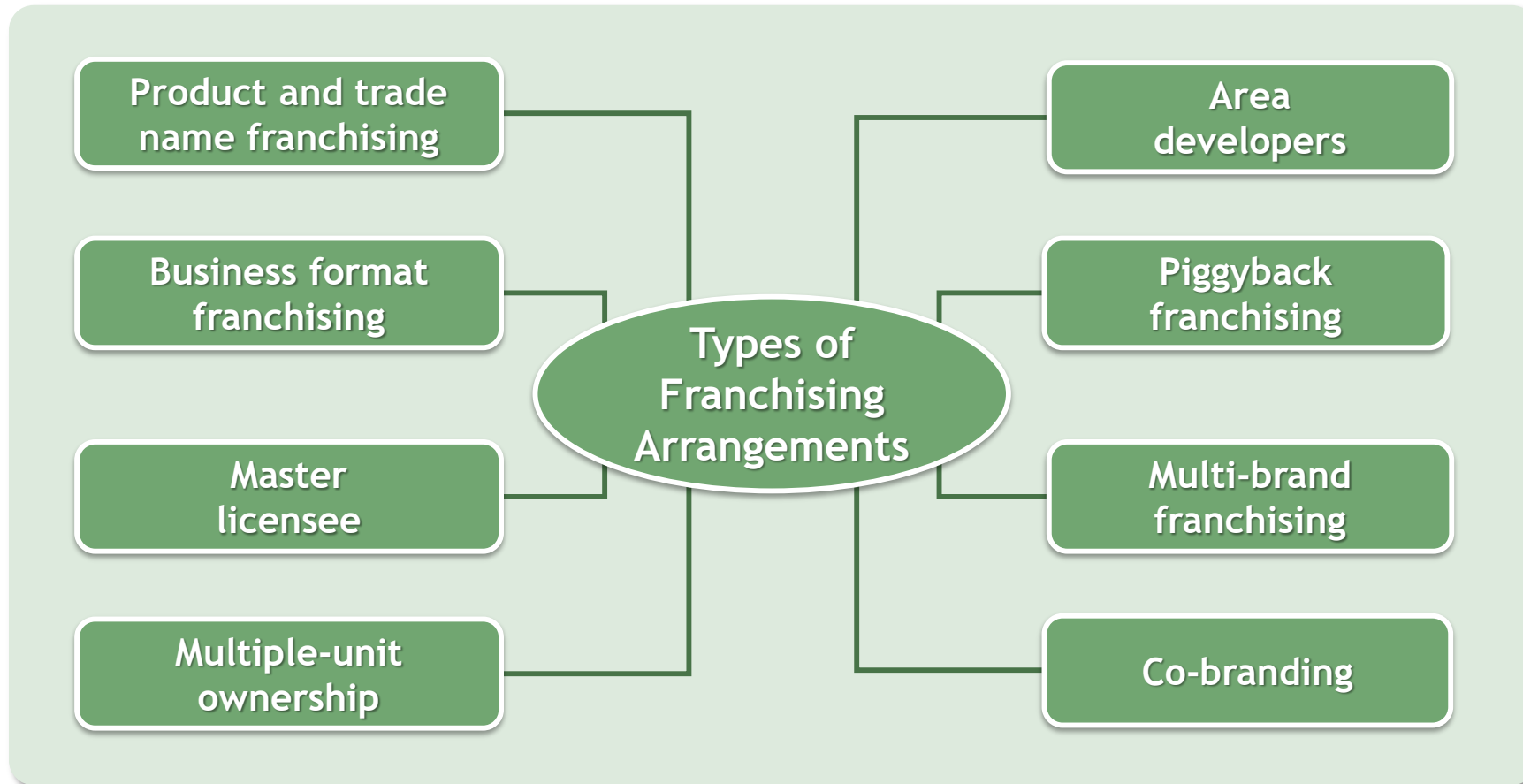


Franchising Terminology

- Franchise Contract
 - The legal agreement between franchisor and franchisee
- Franchise
 - The privileges conveyed in the franchise contract



Franchising Options



Type of Franchising (Philippines)

Type of Franchising

There are three common types of franchising business: product franchising, manufacturing franchising, business format franchising.

Product Franchising

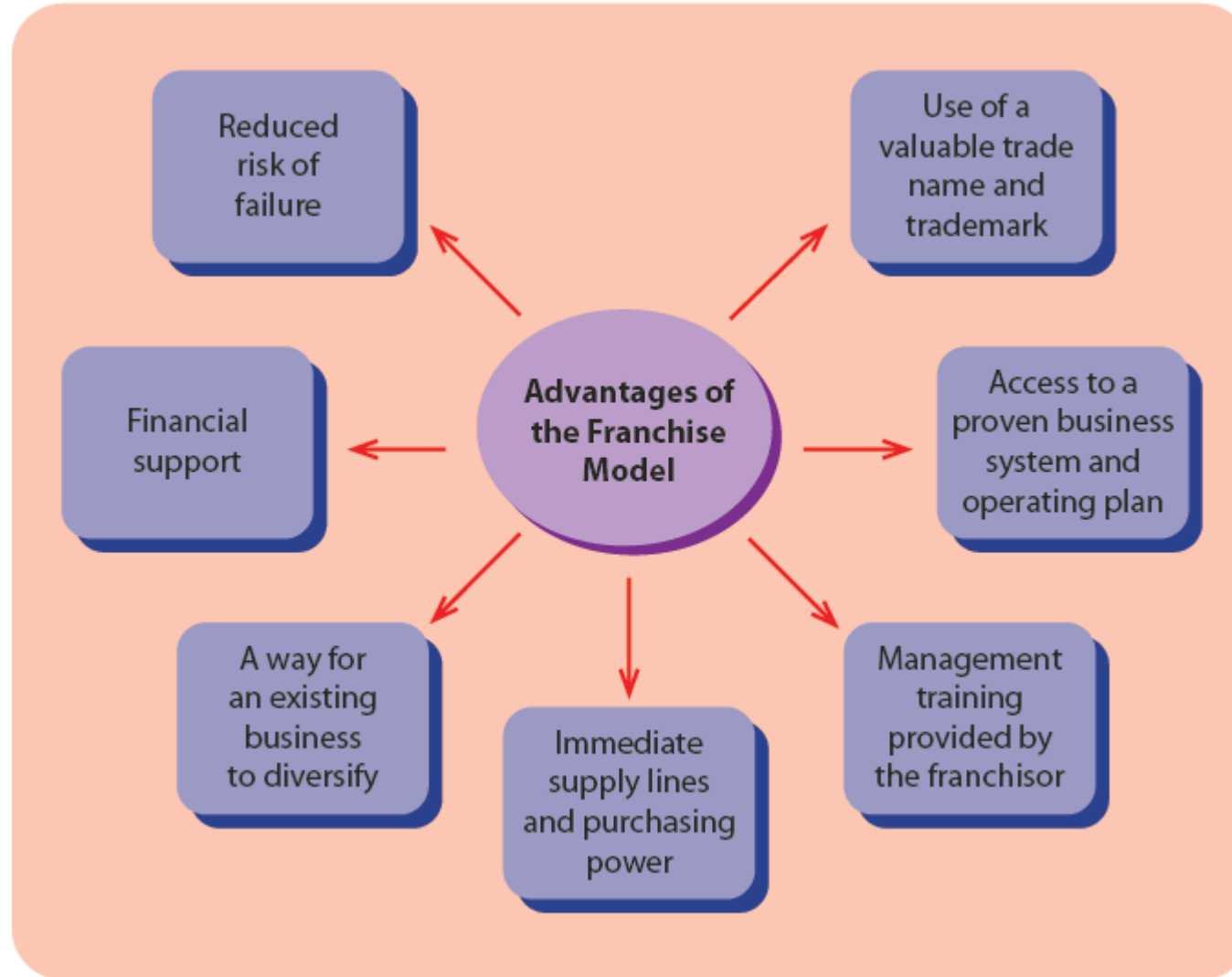
Also known as the trade name franchise, this type of franchise grants to the franchisor the power to give rights to every franchisee in terms of selling its products and the use of trademarks for a fee.

Mostly, it does not include any method of doing the business but the franchisor is always the focal person who should train the franchisee in handling the business. Common examples are car dealerships and service station businesses.

Manufacturing Franchising

Here, the franchisee does not only have the right to sell the products but also has the right to manufacture the product following the manufacturing guidelines. An example is the food and beverage company, Coca-Cola. The franchisor only supplies the syrup ingredients to soft drink bottlers (franchisee) who then proceeds to mix, bottle, and distribute the final product.

Advantages of the Franchise Model



The Pros and Cons of Franchising

- **Probability of Success**

- Proven line of business
- Pre-qualification of franchisee
- Training Support
 - ❖ Franchisor-provided
- Financial assistance
 - ❖ Franchisor assistance
- Operating benefits
 - ❖ Franchisor-aided

- **Franchise Costs**

- Initial franchise fee
- Investment costs
- Royalty payments
- Advertising costs
- Restrictions on business operations
- Loss of independence
- Lack of franchisor support

Concerns About Franchising

1. Misleading or exaggerated earnings claims by franchisors
2. Opportunity behavior by which the franchisor becomes a competitive threat to franchisees
3. Restrictions on franchisees who desire to liquidate their holdings in favor of alternative investment opportunities
4. Conflicts of interest, such as when a franchisor forces franchisees to be captive outlets for other suppliers owned by the franchisor
5. **Churning:** terminating a successful franchise operation in order to resell it and gain additional franchise fees
6. **Encroachment:** locating a new outlet or point of distribution too close to an existing franchisee, causing a material loss of sales
7. Imposing noncompete clauses on franchisees
8. One-sided contracts devised by franchisors
9. The imposition of new restrictions as a requirement of contract renewal
10. Franchisor intimidation of franchisees who attempt to form franchisee associations, seek alternative sources for products, or make other efforts to create a more level playing field

Profile from International Franchise Association (2012)

Glass Doctor

Offering Financial Assistance

In-house financing is available for the initial franchise fee.

Special Incentives

VetFran Participant
International Opportunity Franchise Resale Opportunity
Home Based Franchise

VetFran Incentive

25% of the minimum initial franchise fee for qualified honorably discharged veterans.

Business Established: 1962

Franchising Since: 1977

Franchised Units: 191

Company Owned Units: 0

Start-up Cost \$20,000 to \$125,000

Total Investment: \$107,000 to \$260,000

Company Details

Description

Established in 1962, Glass Doctor is one of the nation's largest providers of glass services for home, auto and business. Services include repair and replacement of windshields, windows, entry door glass, patio doors, shower enclosures, mirrors, tabletops and storefronts. The company's service vehicles carry complete inventory and supplies. Glass Doctor is part of The Dwyer Group.

Training

Upon becoming a Glass Doctor franchisee, you will attend a proprietary training course where our knowledgeable corporate team assists you in putting financial, marketing, management and customer service strategies to work for you. Two weeks of initial training are required, including seminars at the world headquarters, classroom sessions at the Glass Doctor University training center, hands-on workshops at the Glass Doctor University shop (the only one of its kind in the industry), and job shadowing.

Qualifications

Strong Work Ethic, Financially Qualified, High Achievement Drive, Honesty & Integrity, Strong Image/Self-Esteem, Team Player, Willingness To Learn & Apply Proven Successful Business Systems.

Franchisor Controls on Franchisees

- Limiting sales territories
- Requiring site approval
- Imposing requirements on outlet appearance
- Limiting goods and services offered for sale
- Limiting advertising and hours of operation



Evaluating Franchise Opportunities

- **Selecting a Franchise**
 - Personal observation
 - Advertisements
- **Investigating the Potential Franchise**
 - Information sources
 - ❖ Independent, third-party sources
 - Federal Trade Commission
 - Internet
 - Franchise consultants
 - ❖ Franchisors themselves
 - Disclosure documents
 - ❖ Existing and previous franchisees



Entrepreneurs Top 10 Franchises for 2012

Name/Rank	Startup Costs (2009)
1. Hampton Hotels	\$3.7M–13.52M
2. Subway	\$85.2K–260.35K
3. 7-Eleven Inc.	\$30.8K–1.64M
4. Servpro	\$133.05K–181.45K
5. Days Inn	\$202.17K–6.76M
6. McDonald's	\$1M–2.16M
7. Denny's Inc.	\$1.18M–2.4M
8. H&R Block	\$35.51K–136.2K
9. Pizza Hut Inc.	\$295K–2.15M
10. Dunkin' Donuts	\$368.9K–1.74M

Franchise Disclosure Statements

- **Franchise Rule**

- A rule issued by the Federal Trade Commission that prescribes that the franchisor must disclose certain information to prospective franchisees.

- **Franchise Disclosure Document (FDD)**

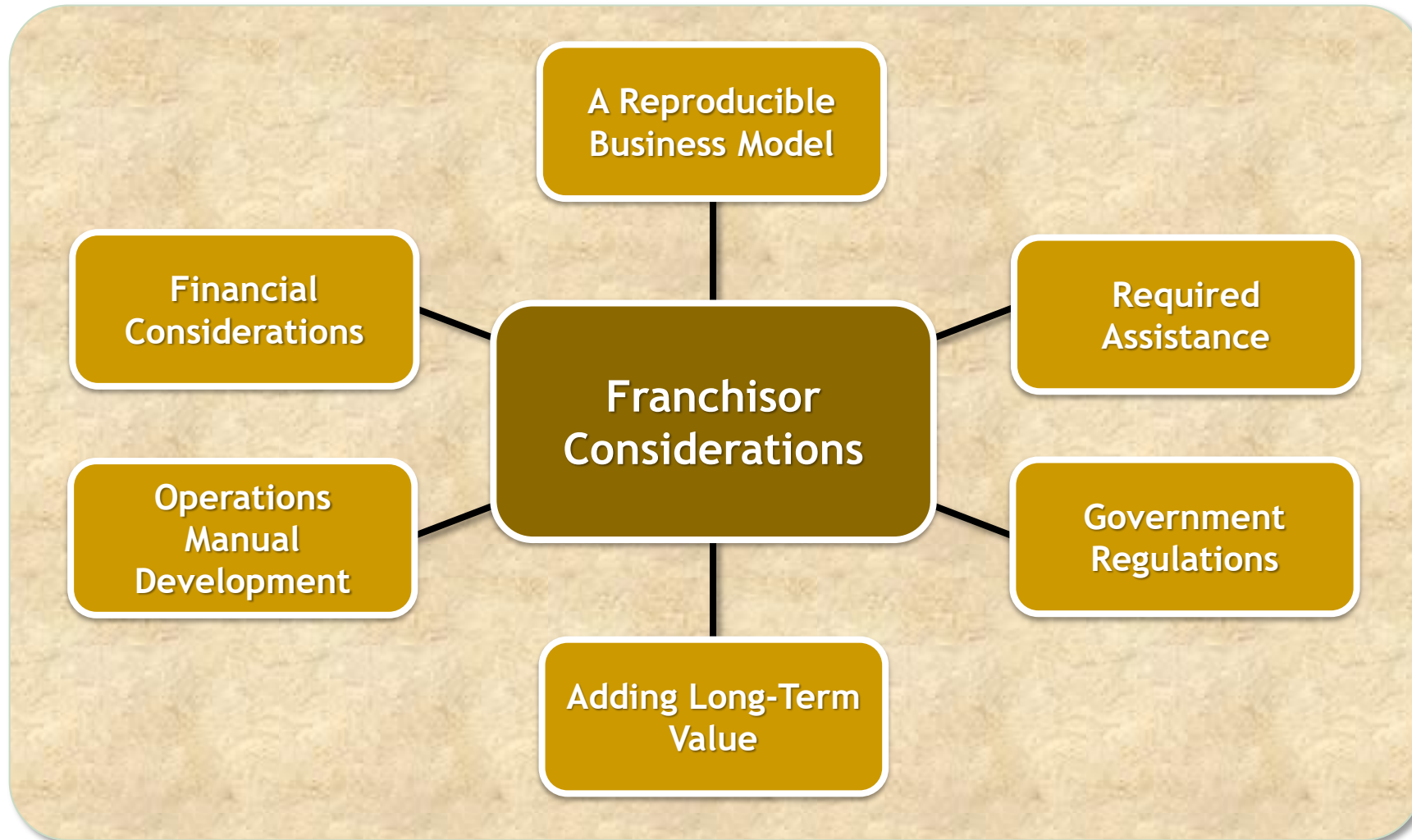
- Is a detailed statement of the franchisor's finances, experience, size, and involvement in litigation.
- Must inform potential franchisees of any restrictions, costs, and provisions for renewal, termination, or sale of the franchise.

Legal Issues in Franchising

- The Franchising Contract
 - Signed with legal counsel present
 - Contains a termination and transfer provision
 - Contains statement of rights to renew contract



Becoming a Franchisor



Becoming a Franchisor

- **Benefits**

- Reduction of capital requirements
- Increase in management motivation
- Speed of expansion

- **Drawbacks**

- Reduction in control
- Sharing of profits
- Increase in operational support costs

Buying an Existing Business

Reduction of
uncertainties
of startup

Acquisition of
ongoing operations and
customer relationships

A bargain
purchase price
for the business

A quick start in
the business



Finding a Business to Buy

1. Identify your interests
2. Consider your talents
3. List conditions for your business
4. Quantify how much you can afford to invest



Pros and Cons of Buying an Existing Business

• Pros

- High chance of success
- Less planning
- Existing customers/suppliers
- Necessary equipment
- Bargain price
- Experienced employees
- Existing business records

• Cons

- Existing problems
- Poor quality of current employees
- Poor business image
- Modernization required
- Purchase price based on inaccurate data
- Poor business location

Investigating and Evaluating Available Businesses

- **Due Diligence**

- The exercise of reasonable care in the evaluation of a business opportunity.

- **Business Brokers**

- Specialized brokers that bring together buyers and sellers

- **Relying on Professionals**

- Accountants
- Attorneys
- Other experienced business owners





Due Diligence for Purchasing a Business

- 
1. Contracts and lease agreements
 2. Financial statements
 3. Tax returns
 4. Real and personal property documents
 5. Bank accounts
 6. Customer lists
 7. Sales records
 8. Supplier/purchaser lists
 9. Contracts
 10. Advertisement materials
 11. Inventory receipts/lists
 12. Organization charts
 13. Payroll, benefits, and employee pension/profit-sharing information
 14. Employee roster
 15. Certification by federal, state or local agencies
 16. List of owners

Finding Out Why a Business Is For Sale

- Possible Owner's Reasons for Selling
 - Retirement due to burnout, old age, or illness
 - Desire to relocate in a different section of the country
 - Decision to accept a position with another company
 - Unprofitability of the business
 - Loss of an exclusive sales franchise
 - Maturing of the industry and lack of growth potential
- *Beware of sellers who may have “cooked the books” to make the business more attractive.*

Examining the Financial Data

- Sign nondisclosure agreement to not reveal confidential information about the business.
- Review financial statements and tax returns for the past five years.
- Recognize that financial data can be misleading.
 - Assets overvalued
 - Expenses overstated/understated
 - Income underreported
 - Unrecorded debts
- Adjust asset valuations to reflect the true state of the business (fair market value).

Valuing the Business

- **Asset-Based Valuation**

- Estimates the value of the firm's assets; does not reflect the value of the firm as a going concern.

- **Market-Comparable Valuation**

- Considers the sale prices of comparable firms; difficulty is in finding comparable firms.

- **Cash-Flow-based Valuation**

- Compares the expected and required rates of return on the amount of capital to be invested in the business.

Nonquantitative Factors in Valuing a Business

- Competition
- Market
- Future community development
- Legal commitments
- Union contracts
- Buildings
- Product prices



Negotiating and Closing the Deal

- Terms of Purchase

- Assets purchase or total entity
- Indemnification clause
- Payment in full or partial payments over time

- Closing the Sale

- Best handled by a third party
 - ❖ Bill of sale
 - ❖ Tax certifications
 - ❖ Payment-to-seller agreements and guarantees



Key Terms

area developers

business brokers

business format franchising

churning

co-branding

due diligence

encroachment

fair market value

franchise

franchise contract

Franchise Disclosure Document
(FDD)

franchisee

Franchise Rule

franchisor

master licensee

multibrand franchising

multiple-unit ownership

nondisclosure agreement

piggyback franchising

product and trade name

franchising