Franchising – consolidation and corporatisation to fuel further growth

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Franchisor performance is a lagging indicator of franchisee performance. In order to understand the underlying viability of a franchisor, it is necessary to analyse and understand the health of the underlying franchisee network.

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The fortunes of franchisors and their franchisees are intertwined. Whilst much attention has been paid to the impact on franchisees when franchisor businesses fail, franchisors are also exposed to the failure of their franchisees.

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Larger franchisors are taking advantage of an increasing number of smaller players who are struggling to maintain profitability by engaging in consolidation activity. Australian franchising is expected to experience a consolidation path similar to that of the US franchising industry five years ago.

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Smaller franchisors are struggling to maintain and grow their networks. There are clear economies of scale enjoyed by the larger players.

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The franchise industry (perhaps unfairly) has a reputation for disputes between franchisors and franchisees and of rogue franchisors taking advantage of “mum and dad” franchise operators. The industry needs to clean up this tarnished image and sell the strong growth story to potential franchisees and credit providers.

1 Industry snapshot

Franchising in Australia is a $200 billion industry comprising around 1,000 franchise systems and approximately 69,000 operating units.

Revenue	Annual growth 2007 - 2012	Annual growth (proj.) 2012 - 2017
$200 billion	3.4%	3.3%

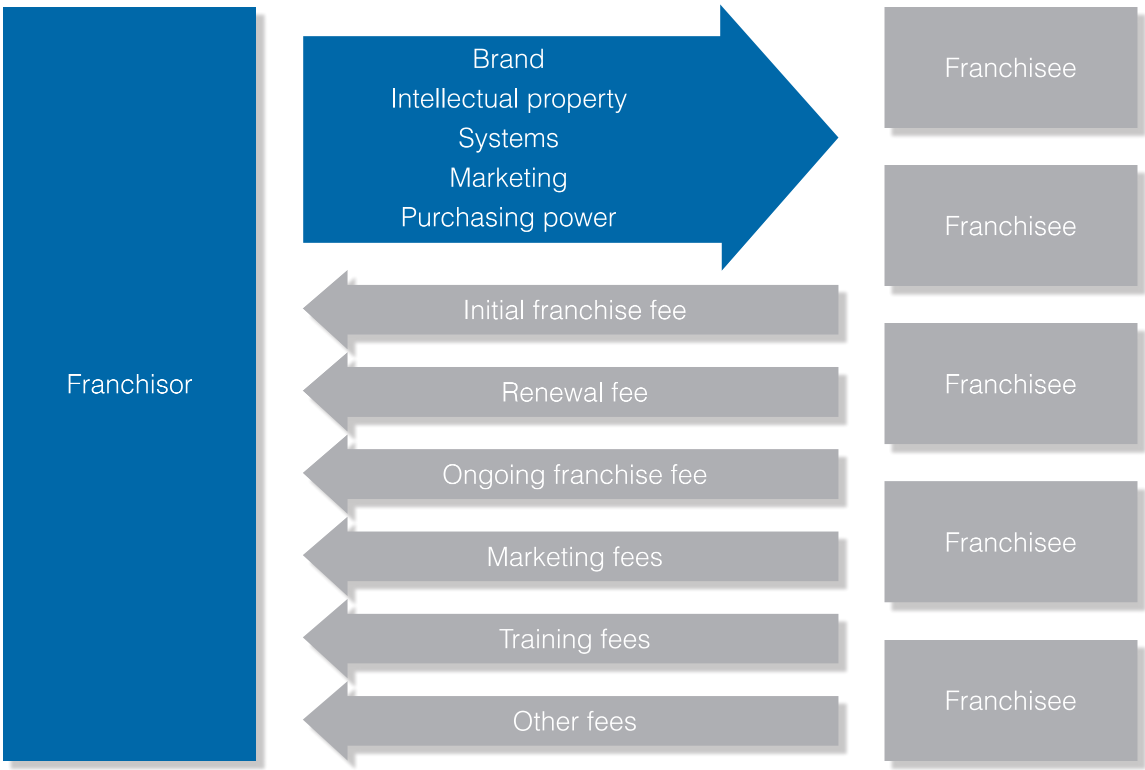
Profit	Franchise systems	Franchise units
$8 billion	977	69,000

Source: IBIS, Griffith University

"Australia is the most franchised nation in the world, with three times as many franchises per capita compared with the United States."

2 The franchise model

Income streams vary according to the sector in which the franchisor operates and the terms of specific franchise agreements. However, they typically include an initial up front franchise fee, ongoing (annual) franchise fees, marketing levies and fees for other services.



Source: KordaMentha

Fee structure

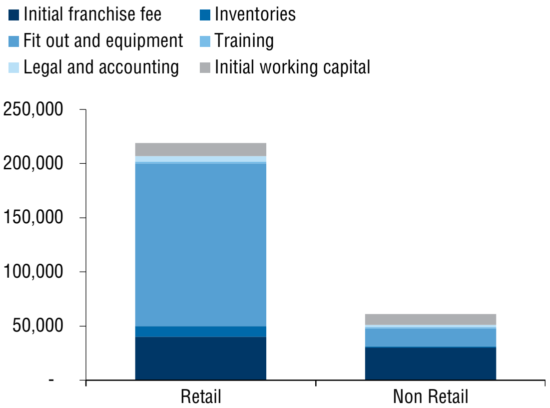
Ongoing franchise fees are typically a fixed amount or a percentage of franchisee revenue (or, more rarely, franchisee profitability).

The primary benefit of a fixed fee arrangement for a franchisor is the predictability of cash flow. This arguably shields the franchisor from downside risk in franchisee network performance, but such protection is short lived. The franchisor remains exposed to the franchisee network performance through its ability to collect fees owing (debtor recoverability) and generate further growth in the network.

A percentage of revenue model allows the franchisor to participate directly in the trading performance of franchisees and thereby more aligns the interests of both franchisor and franchisee. Although conflicts of interest can still be evident where franchisors seek to promote high turnover locations that may lack sustainable profitability (e.g. high rent shopping centres).

Initial franchise fee

Average startup costs



Source: Franchising Australia 2010, Griffith University

The vast majority (98%) of franchisors charge an initial franchise fee. The average fee is $40,000 for retail franchises and $30,000 for non-retail franchises, but the range is wide and can be as high as $250,000.

Initial franchise fees are only one of a number of costs incurred by incoming franchisees. Funding for working capital, fit out, training and other costs means overall startup costs average $275,000 for retail franchises and $89,000 for non-retail franchises. Again, the range is wide and total startup costs can exceed $1.0 million.

Ongoing franchise fees

Typical range	Flat rate	% revenue
Ongoing franchise fee	$1,640 to $24,000	1% to 35%
Marketing levy	$360 to $14,400	0.5% to 5%
Training fee	$120 to $12,000	0.5% to 1%

The majority (89%) of franchisors require their franchisees to pay ongoing fees. Approximately 40% charge a flat fee structure and 60% charge fees based on a percentage of revenue.

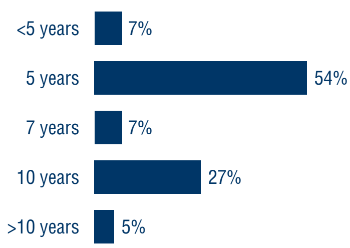
Both franchisor and franchisees will generally contribute to the cost of marketing initiatives, funded through a marketing levy. Franchisees may pay marketing levies directly to the franchisor. Under this approach the franchisor takes on responsibility for all marketing liabilities, which may be significant.

Alternatively, marketing levies may be paid by both the franchisees and franchisor to a dedicated independent marketing body. Whilst franchisees typically demand input into the planning of marketing initiatives and transparency in relation to the allocation of the marketing funds, franchisors should ideally retain ultimate control over the marketing initiatives as these have significant implications for the positioning of the franchise brand.

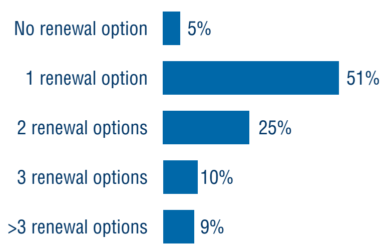
Renewal fees

Franchises are granted for a fixed period of time and most franchise agreements run for an initial period of five years. The majority of franchisors (95%) offer renewals, for a fee.

Term of franchise agreements



Renewal options



Source: Franchising Australia 2010, Griffith University

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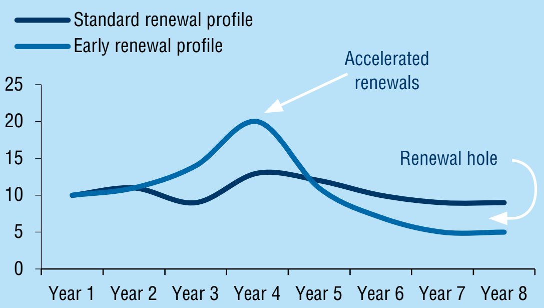
Beware the renewal hole



Source: KordaMentha

Franchise renewal fees may be 'lumpy' depending upon historic patterns of growth within a franchise system. Franchisors may at times seek to actively renew agreements prior to their expiry (generally by offering a discounted renewal fee) as a means of generating cash flow and improving short term trading performance. This may lead to problems in the medium term though, as a future 'renewal hole' may develop.

Supplier rebates

Franchise networks offer significant purchasing power that often results in substantial supplier rebates. These may include direct purchasing rebates, advertising rebates and shop fit contributions from landlords.

Supplier rebates may be passed directly on to franchisees, or they may be retained by the franchisor, depending on the terms of the franchise agreement.

Fees for service

Franchisors (particularly large networks) often provide support services to franchisees including information technology support, sales and business training, lease negotiation and management, regional business development and accounting services.

Fee income for such services may be on a cost recovery basis or may represent profit centres in their own right. Opportunities for franchisors to provide "add on" services may be influenced by the nature of franchisees ("mum and dad" operators versus multi-unit corporates).

How does a franchisor really make money?

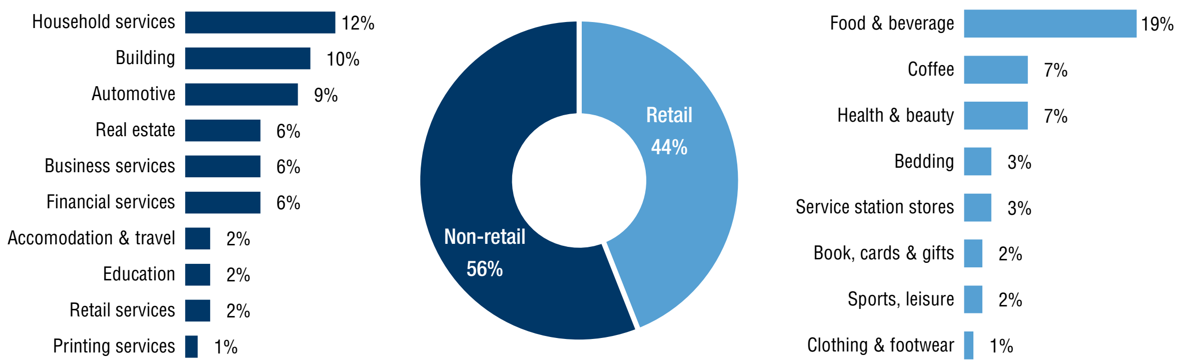
Given the range of income streams available to a franchisor, they can follow a number of different profitability models.

Some are effectively wholesalers, others retailers, or real estate or business portfolio players.

The key to understanding a franchisor is to identify the particular key drivers of its profitability.

3 Products and services

The profile of the Australian franchising industry is changing. Whilst retail trade continues to account for 44% of the sector, its dominance is declining as non-retail sectors such as personal services and business and financial services grow in response to changing consumer demands. By contrast, the relative share of food & beverage (the largest retail segment) continues to fall in the face of a saturated market for fast food, café and juice operators. These trends will continue.



Source: ACA Research, July 2011

Growth driven by rising discretionary incomes and evolution of time poor, cash rich consumers who are willing to pay to outsource traditionally domestic tasks.

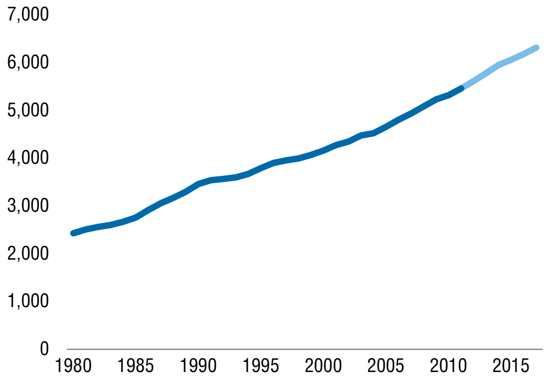
Retail trade generally strong in the past five years (notwithstanding a period of decline in 2008 and 2009) in line with consumer sentiment. However, future growth will be limited by market saturation (particularly fast food, café and juice markets).

Demographic and economic trends

Franchising is projected to grow at an average annual rate of 3.3% over the next five years. Long term demographic trends will continue to drive growth in service orientated franchise systems in particular.

Increasingly time poor consumers will continue to look to outsource household tasks...

Female participation in the labour force

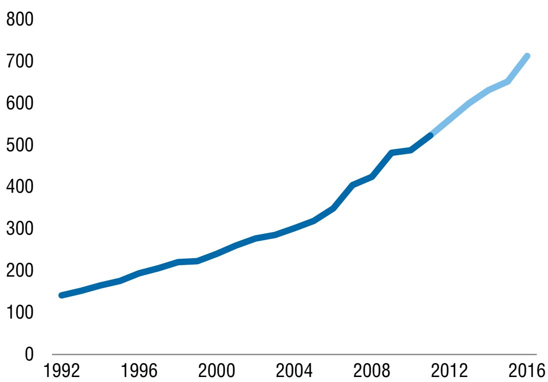


Source: ABS, IBIS

Female workforce participation rates have increased significantly over the last 20 years, increasing by an average of 2.8% each year since 1980, and slowing in the last five years to an average of 2.6%. The total female labour force is projected to continue to increase, reaching 6.3 million in 2017. With this continued growth, the task of balancing work and home responsibilities will become increasingly difficult.

....and favourable economic conditions over the next five years will facilitate the shift from “do-it-yourself” to “do-it-for-me”.

Real household discretionary income



Source: ABS, IBIS

Real household discretionary income measures the amount of income available for consumers to use to either spend on luxuries (as opposed to “necessities” such as food, clothing, rent, health, etc.) or to save.

This measure is forecast to grow at an annualised rate of 6.4% to reach $713.9 billion by 2016. Australia will continue to benefit from high levels of international demand for commodities, which will continue to place upward pressure on wages and grow disposable income levels. Furthermore, the commodities boom is one of the key contributors to the strength of the Australian dollar, which helps to keep down the cost of imported goods, reducing the proportion of disposable income households will need to spend on necessary items.

5 Growth and outlook

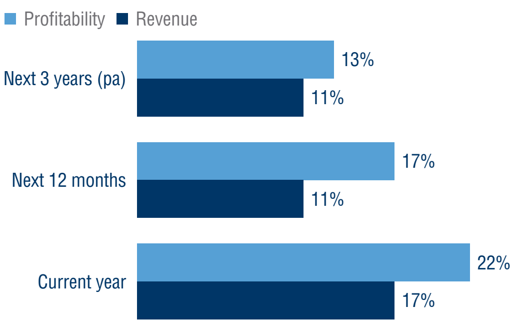
During 2010, the franchising sector performed strongly, both in absolute terms and compared with the private business sector as a whole...and will continue to deliver double digit growth over the short to medium term.

2010 was a strong year for franchisors, with average revenue increasing 17% and profitability increasing 22%. This compares favourably with private businesses generally, which grew revenue at 6% and profitability at 7% over the same period (per PwC Private Business Barometer report).

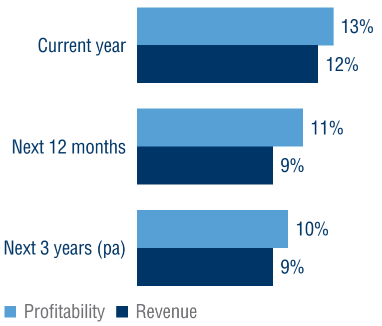
Retail based franchisors performed more strongly than their service counterparts, with revenue and profitability growth of 22% and 26%, against service based revenue and profitability growth of 12% and 18%.

The outlook remains positive, with double digit revenue and profitability growth projected over both the short and medium terms.

Franchisors



Franchisees



Source: ACA Research, July 2011

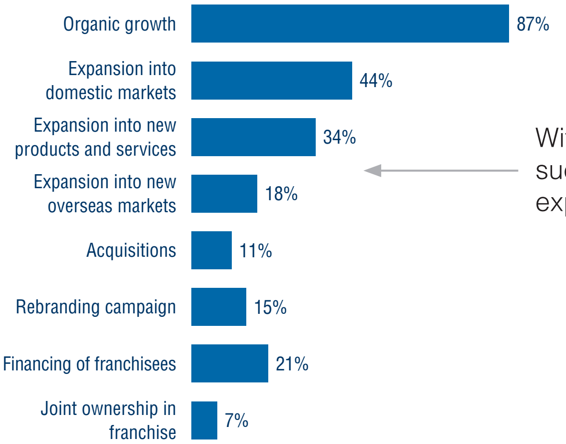
2010 was also a strong year for franchisees, with average revenue increasing 12% and profitability increasing 13%. Whilst these rates were lower than those achieved by franchisors, they were still considerably higher than private business generally.

Unlike franchisors, the retail/non retail growth rates were broadly similar.

The outlook remains positive, with close to double digit revenue and profitability growth projected over both the short and medium terms.

Growth is expected to be driven primarily through organic growth and expansion in domestic markets.

Growth strategies (% of respondents)

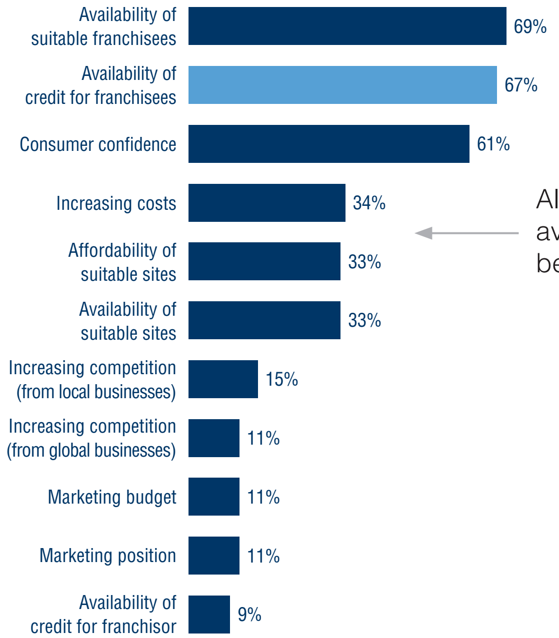


With a reducing focus on riskier growth strategies such as product and service diversification and expansion into new overseas markets.

Source: ACA Research, July 2011

Availability of suitable franchisees (and credit for them) will continue to be key challenges to growth.

Challenges to growth (% of respondents)



Although consumer confidence and the availability and cost of suitable sites are also becoming increasingly important considerations.

Source: ACA Research, July 2011

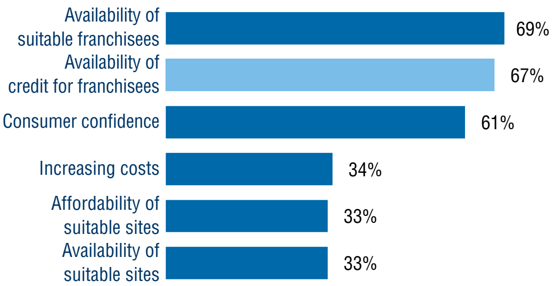
6 Bank funding

The availability of credit for franchisees is regarded by franchisors as a major impediment to growth. This is unusual, given the relative strength of the franchise industry against private business generally, and the risk mitigant of investing in an established business model with a track record and ongoing franchisor support.

The reasons are unclear, but what is clear is there are major opportunities for both banks and franchisors to engage, identify and address any impediments.

The availability of credit for franchisees is a major impediment to growth.

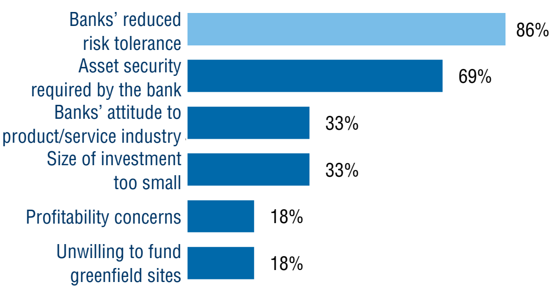
Key challenges to meeting growth targets
(% of respondents)



Difficulties in obtaining funding

Franchisors primarily attribute this to the banks' reduced appetite for risk in the wake of the GFC...

Reasons for difficulties in obtaining funding (% of respondents)



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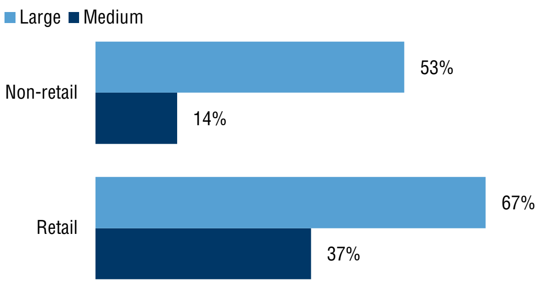
But franchisors themselves could do more to educate the banks and obtain accreditation.

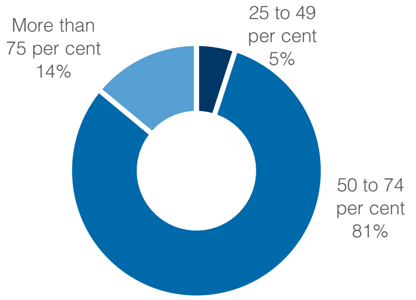
Bank accreditation



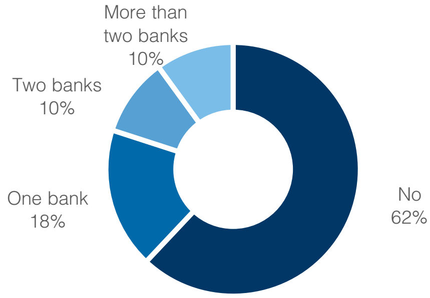
There is a higher prevalence of accreditation amongst larger franchise networks (greater than 100 units) than medium networks (20 to 99 units), perhaps reflecting the banks' increased willingness to engage with more established franchisors.

With banks only willing to lend to 50% of any single franchise network (on average), and with only 20% of franchise systems currently accredited with two or more banks, the first step is clearly increased accreditation.

Proportion of a network that banks are willing to lend to



Bank accredited franchise systems



Source: ACA Research, July 2011

> "Given that banks expect a demonstrated return on investment, and that accreditation can be the deciding factor in whether franchisees are able to access more funding, there is clearly more work to make sure our systems are giving themselves the very best prospect of getting funding for expansion."

Steve Wright, Franchise Council of Australia

7 International expansion

Overseas (particularly US-based) franchise systems are increasingly viewing Australia as an attractive market for expansion.

While the Australian franchise market is considered small on an international scale, the entry of large foreign players such as Costco and Aldi into the Australian market has spurred greater interest among other operators attracted by the strength of the Australian dollar, the strength of economy and a recognition of Australia as a safe haven.

The Australian franchise arena has also become a key destination for international residents looking to migrate to Australia. In particular, demand from China has been driven by Australia's attractive lifestyle and the proven success of franchise models. A number of franchises have recognised this trend and have built relationships with migrating service agents to make their franchise opportunities available to overseas residents.

Overseas (particularly US-based) franchise systems are increasingly viewing Australia as an attractive market for expansion. The past few years have seen the entrance of major brands such as Costco, Aldi and The Gap.

28% of Australian franchisors have expanded overseas. For 70% of these, the first destination was New Zealand, reflecting the cultural and economic similarities between Australia and New Zealand and relative proximity.

8 Understanding underlying performance

Franchisor performance is a lagging indicator of franchisee performance. In order to understand the underlying viability of a franchisor, it is necessary to analyse and understand the health of the underlying franchisee network.

Network viability assessment

Some franchise agreements require franchisees to report detailed financial information to their franchisors. Other agreements only require snapshot information such as gross revenue.

Where detailed financial information is not available, franchisors rely upon a number of non-financial indicators to monitor network performance:

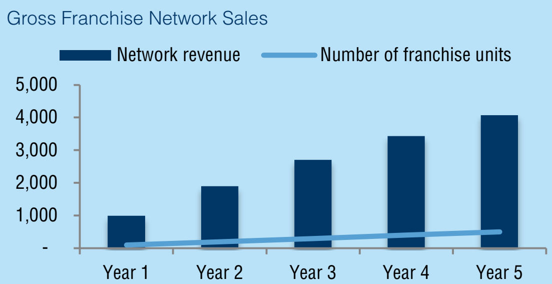
- Trends in the quantum of centralised purchasing
- Ageing of amounts due from franchisees
- Franchisee business failures
- Percentage of overall network currently for sale
- Compliance with fit out and equipment specifications
- Level of ongoing investment by franchisees

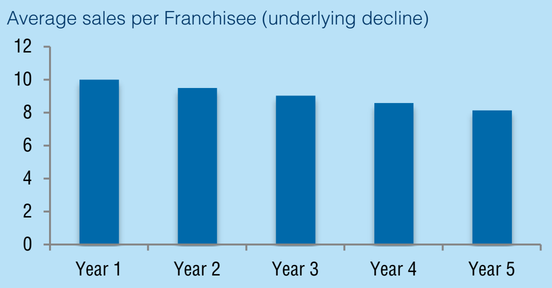
When assessing the financial performance of individual franchise units (particularly smaller, labour intensive service units), it is important that a cost is included for the franchisee's wage or dividend. Assessing whether franchisees are earning a reasonable return on their investment may be complicated by the fact that some franchises (particularly service based) provide "off the books" cash income opportunities.

Comparative sales analysis

Revenue growth within a franchise network can be organic (existing franchise units increasing their revenue) or through growth in the number of franchise units (new franchise territories developed).

In order to identify underlying trends in network viability it may be necessary to calculate comparative revenue (i.e. revenue per franchise unit). This approach may identify underlying sales decline despite growth in overall network sales driven by an increase in the number of franchisees. This growth is ultimately unsustainable.





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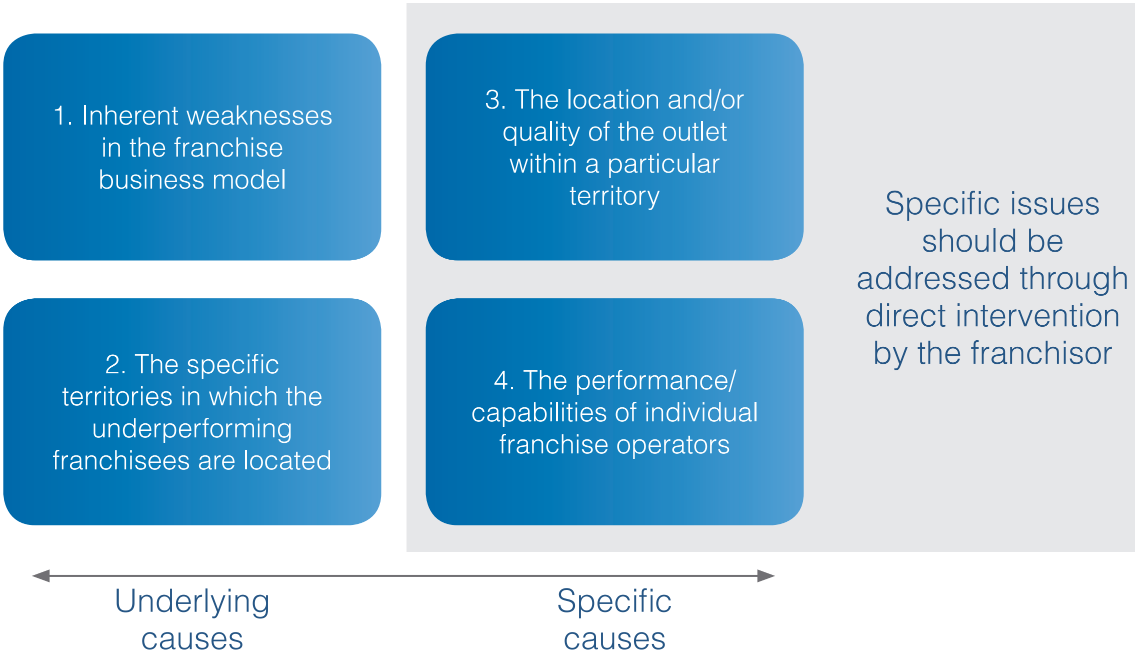
Underperformance

Network viability issues may be due to a number of factors:



Source: KordaMentha

Where the overall business model and franchise territories are strong, then improvement in network performance may require management of specific underperforming franchisees:

- Identify annual franchisee "churn rate"
- How long does it take, on average, to find a replacement franchisee
- Is the identification of underperforming franchisees and their replacement with stronger franchisees actively and appropriately managed by the franchisor?

9 Co-dependence

The fortunes of franchisors and their franchisees are intertwined. Whilst much attention has been paid to the impact on franchisees when franchisor businesses fail, franchisors are also exposed to the failure of their franchisees.

Debtor exposure

Bad debt exposure is generally the primary balance sheet concern for franchisors. It is critical that an appropriate bad debt provision is maintained and bad debt issues are flagged in a timely manner.

Franchisors often place reliance on their ability to recover aged debts when franchises are transferred to new franchisees. Franchise agreements normally require franchisor approval before franchisees can be transferred and thus approval may be withheld until the funds raised through the sale are used to settle all debts with the franchisor. However, if overall network performance is deteriorating then there may be insufficient "value" in a particular franchise to settle all commitments.

In order to mitigate the risks associated with doubtful debt exposure the franchisor should develop and implement a strict control process:

- Actively monitor debtor ageing
- Where ageing is deteriorating, assess whether this is due to an inability to pay (poor trading performance, other external liabilities) or a reluctance to pay (using the franchisor as a source of "soft" funding, or withholding payment due to dispute or dissatisfaction)
- If there is an inability to pay then consider what support can be provided to improve trading performance or assist the franchisees in transferring the territory to a financially stronger purchaser
- If there is a reluctance to pay then consider placing the franchisee "on stop", withdrawing franchisor support and commencing legal action.

Centralised Invoicing

Major suppliers will often require centralised ordering by the franchisor on behalf of the franchisees to allow access to volume rebates. Franchisors may also choose (or be required by suppliers) to retain the financial relationship with suppliers and centrally invoice franchisees.

Centralised invoicing has the potential to be cash flow positive for a franchisor. Volume purchasing should enable the franchisor to negotiate favourable credit terms with suppliers. If these terms exceed those agreed with franchisees then centralised invoicing represents a soft form of franchisor financing.

However, if network viability deteriorates then franchisees will generally "stretch" the agreed credit terms with the franchisor. If actual credit terms stretch beyond those agreed between the franchisor and supplier then centralised invoicing represents a working capital drain. Centralised invoicing also exposes the franchisor to significant financing risk in the event that franchisees fail and are unable to meet their debt obligations to the franchisor as the franchisor's obligation to suppliers remains.

Brand damage

The failure of a franchisee (particularly in retail systems where there is high exposure to the consumer) can have a detrimental impact on brand value. One way franchisors can mitigate this is to ensure they have step-in rights which allow them to effectively repossess failed franchise units and run them as corporate stores or re-sell them to a new franchisee.

This approach is contingent on the franchise agreement providing step-in rights to the franchisor. Step-in rights also need to be supported by debenture charges which enable the franchisor to take possession of the business and assets of underperforming franchisees.

However, repossession of underperforming franchises significantly alters the franchisors funding requirement as the franchisor must fund both the working capital requirements of the franchise (such as inventory) as well as absorb any losses the franchise may incur during the franchisor's period of control.

Contingent lease liabilities

Franchisors may be committed to significant contingent lease liabilities in respect of franchisee property leases. This generally arises for two reasons:

- Landlords insisting on the franchisor acting as guarantor to "mum and dad" franchisees with limited financial resources
- Franchisors acting as head lessee and sub-letting to franchisees in order to improve "step-in" rights in the event the franchisee fails.

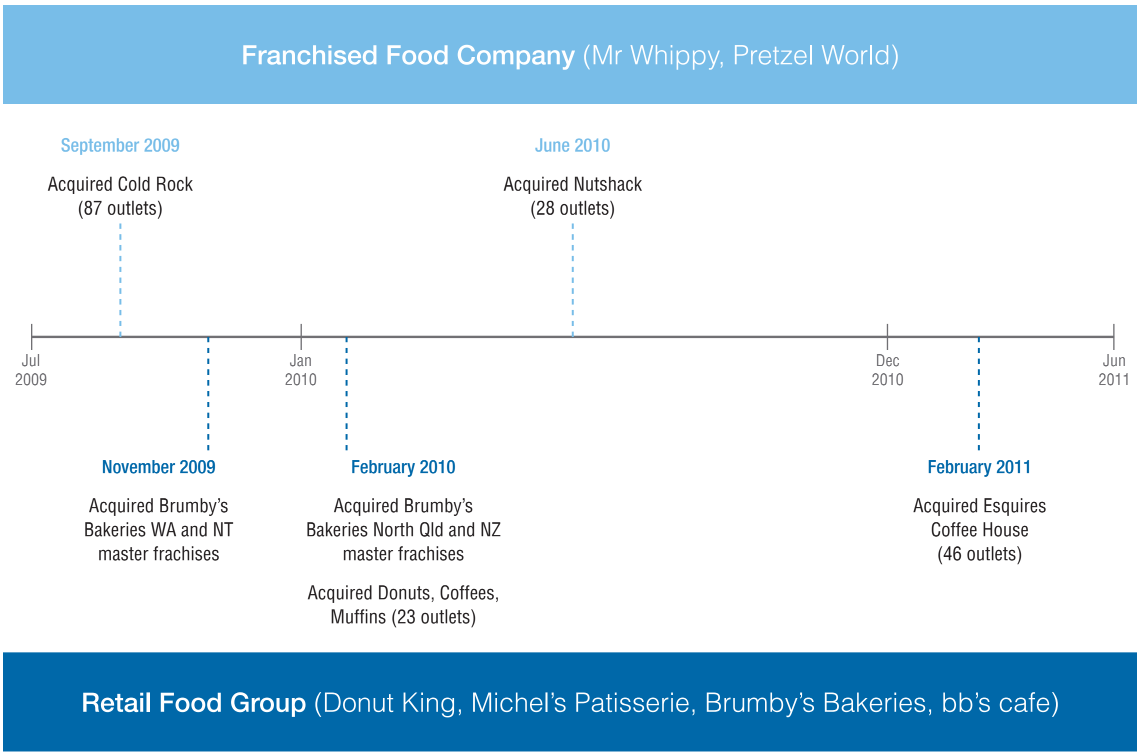
Where possible any lease liabilities taken on by the franchisor should be mitigated by personal guarantees provided by the relevant franchisees.

10 Concentration and consolidation

Australia is the most franchised nation in the world, with a higher number of franchise systems per capita than even the US. The majority of these franchise systems lack critical mass and Australia is effectively over supplied. The industry is ripe for consolidation.

Larger franchisors are struggling to fuel organic growth due to a dwindling supply of retail sites (at the right price) and potential franchisees. At the same time retail margins across retail-related franchises have tightened in response to heightened competition and fluctuations in consumer confidence.

In response, a number of larger franchisors have taken advantage of the increasing number of smaller players who are struggling to maintain profitability by engaging in consolidation activity. Australian franchising is expected to experience a consolidation path similar to that of the US franchising industry five years ago.



"In Australia, 150 franchise systems have over 70% of Australia's franchisees in them. The bigger brands are dominating."

Rod Young, DC Strategy

"Healthy pipeline of acquisition opportunity driven by motivated vendors."

Retail Food Group, 2011 Results Presentation

"I think consolidation is a natural thing. As a franchisor you have to plan for a growth phase and understand that when you reach a certain stage you may not be able to offer the support to your franchises. If you can't expand you need to be looking at mergers and increasing economies of scale."

Michael Sherlock, Chairman, Franchised Food Company

11 Economies of scale

Whilst franchisor profitability, like most businesses, is influenced by a range of factors, larger players have tended to perform better than smaller players.

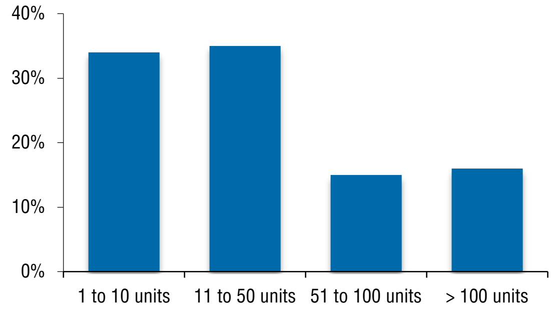
Larger franchisors have benefited from the advertising, brand awareness and market penetration achieved by having a collective group of franchises all operating under one brand.

Smaller players (particularly those with less than 20 to 30 franchisees) are more likely to struggle with the economics of maintaining a brand across a relatively small network. Smaller networks are also more susceptible to the fluctuations in consumer spending patterns that have occurred over the past few years.

Whilst smaller franchisors still flourish in niche sectors, there have been a number of smaller franchisor failures in saturated retail markets such as furniture, electrical goods and bedding. Smaller juice and coffee franchises are also struggling for similar reasons.

In 2009 70% of franchisors were small players with less than 50 franchise units, although their prominence is steadily reducing and was down from 74% in 2008. The median number of franchised units in 2009 was 22, up from 17 in 2008. This suggests that a large portion of the franchise industry lacks the critical size to adequately invest in marketing and infrastructure for the longer term.

Number of franchise units per franchise systems



Source: Franchising Australia 2010, Griffith University

"Once you get to 30 franchises you need all the speciality departments like purchasing, training, IT, research and development, marketing etc. In order to be of full service to your system you need these systems in place."

Michael Sherlock, Chairman, Franchise Food Company.

"You can make money out of having 25 stores or less but that means you're taking all the money out of the business and not reinvesting in it. So franchisors need to have 40 or 50 to actually start being profitable themselves."

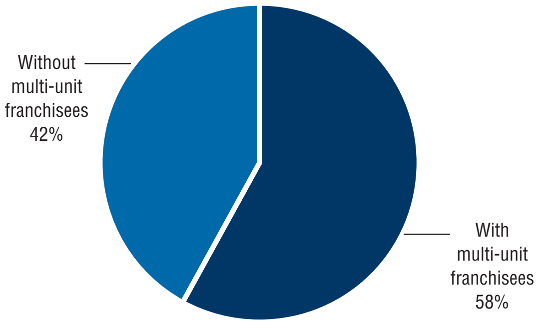
Nicola Mills, CEO Pacific Retail Management.

12 Multi-unit franchises

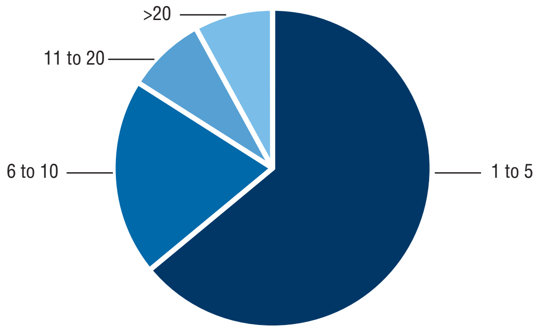
A cornerstone of the franchising business model is the harnessing of the owner-operator effect and, to that effect, approximately 75% of franchise units in Australia are owned individually. However, the prevalence of multi-unit franchising (whereby an individual or corporate owns and operates more than one franchise unit within a franchise system) is growing, with almost 60% of franchise systems containing at least one multi-unit franchisee. Franchisees often perform above corporate-owned store managers and are often a good choice in remote and regional areas as they do not require area manager supervision.

Anecdotal evidence suggests Australian franchisors are increasingly encouraging multi-unit franchisees as markets mature and economic conditions restrict the pool of available franchise candidates. This trend has been evident in a number of mature markets such as the United States for many years.

Franchise systems with multi-unit franchisees



Number of multi-unit franchises



Source: Franchising Australia 2010, Griffith University

The highest prevalence of multiple unit ownership exists in food retail (accounting for around a third of all franchise systems with multiple unit ownership), with retail franchise systems accounting for around a further 15%.

The prevalence is also higher in larger and more experienced franchise systems. According to a survey of franchisors conducted by Griffith University in 2009, only 21% of franchises with less than ten years' experience encouraged the growth of multi-unit ownership. This reticence is well placed. Whilst multi-unit franchising might be tempting for new systems that are striving for double digit growth, if multi-unit franchising is begun too early in a network's development, the balance of power and influence between franchisees could become unstable, with a small number of franchisees holding a significant proportion of units within a franchise system. If adopted later when a system is larger and more developed, the risk of disproportionate power and influence is lessened.

If introduced and managed appropriately, multi-unit franchisees can strengthen a franchise system in a number of ways:

- Multi-unit franchisees tend to have greater access to capital and more developed business acumen than single unit franchisees. They therefore tend to be more responsive to initiatives introduced by franchisors.
- They can build longer term careers for staff, offering a variety of roles at different locations. Talented staff can therefore be encouraged to remain within a particular franchise system.
- Franchisor costs associated with franchise recruitment, compliance and support are reduced.
- The risks associated with taking on a new (and untested) franchisee are greatly lessened.

Franchisors recognise these benefits. Almost half (48%) of franchisors with multi-unit franchisees believe they operate at a level higher than single unit franchisees. Only 10% of franchisors reported an operational level below that of single unit franchisees.

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Regulation

The Franchising Code of Conduct regulates the conduct of franchising. Compliance with the Code is monitored by the Australian Competition and Consumer Commission.

Disclosure

Under the code, franchisors and master franchisees (or sub-franchisors as they are sometimes known) must give a franchisee:

- a copy of the code
- a disclosure document in the required form
- a franchise agreement in the form it is to be executed

at least 14 days before the franchisee enters into, renews or extends a franchise agreement or pays a non-refundable deposit in relation to a franchise agreement.

Franchise agreements

The code requires that franchisors provide their franchisees with certain rights in relation to franchise agreements. In particular:

- A franchisee may terminate a franchise agreement within seven days after entering the agreement, or paying any non-refundable money, whichever is earlier. If the franchisee chooses to exercise their cooling-off rights, they must be given a refund minus any reasonable expenses incurred by the franchisor within 14 days.
- A franchisor is prohibited from inducing franchisees or prospective franchisees not to form an association or associate with other franchisees or prospective franchisees for a lawful purpose.
- A franchise agreement entered into on or after 1 October 1998 must not contain, or require a franchisee to sign a statement that releases the franchisor from general liability towards the franchisee.
- A franchise agreement must not contain, or require a franchisee to sign, a waiver of any verbal or written representation made by the franchisor.

Dispute Resolution

Every franchise agreement entered into on or after 1 October 1998 must set out a dispute handling procedure that complies with the code. Any party to a franchise agreement who has a dispute with another party to the agreement may engage the code's dispute resolution procedure. The Office of the Franchising Mediation Adviser provides mediators for resolving disputes using the dispute resolution procedure set out in the code.

Source: Australian Competition and Consumer Commission

Tarnished image

The franchise industry (perhaps unfairly) has a reputation for disputes between franchisors and franchisees and of rogue franchisors taking advantage of ‘mum and dad’ franchise operations.

A 2006 study by the University of New South Wales highlighted the difficulties franchisees face when their franchisor is subject to insolvency proceedings and a more recent survey in 2010 indicated 22% of franchisors were engaged in some form of formal dispute with one or more of their franchisees.

However, in reality this represents less than 3% of the 69,000 franchise units in Australia.

As a result of the perception of disputes within the franchising industry, it has been the subject of intense political scrutiny. Since 2008, with the launch of a Federal Government enquiry into the Franchising Code of Conduct, the industry has seen three separate parliamentary inquiries, changes to the Franchising Code (in July 2010) and attempts in South Australian and Western Australian to introduce private member’s bills aimed at increasing the regulation of franchising activity in those states.

At the 2010 National Franchise Convention, Nick Sherry, the Federal Small Business Minister, assured the industry the Federal government did not intend to make any further amendments to the Franchising Code before 2013 although the fate of the state based private member’s bills are still uncertain.

> “To provide the sector with the stability and confidence it deserves, the Government doesn’t intend to review the Franchising Code again before 2013.”

Nick Sherry, Federal Small Business Minister, October 2010

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