How Can You Attract Existing Successful Area Developers Without an Earnings Claim?

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Based on recently released FranData statistics, about 30,000 or 11 % of all franchisees in the FranData database operate more than one unit, and approximately 1/3 of those multi-unit franchisees or about 7,000 franchisees, operate multiple concepts. These statistics show a growing trend toward multi-concept ownership and are expected to grow dramatically over the coming years. Multi-brand franchisors can groom successful operators internally from their other systems. However, if you are a franchisor trying to attract successful operators from other franchise systems, you cannot use the same sales approach you use with single-unit franchisees.

In fact, successful multi-unit developers are often looking for new opportunities to maximize their infrastructure and maintain their growth rates, when existing opportunities are exhausted or the best markets are developed.

According to Rocco Fiorentino, the President of Freedom Rings, LLC an area developer for Krispy Kreme Doughnuts, the single most important element of any new franchise opportunity is the unit economics. "If I don't have an earnings claim or reliable data on unit economics, it is extraordinarily more difficult for me to evaluate a potential franchise opportunity. In a food concept, it is very important to understand the business model and the average gross margin before I can evaluate the effect of the new business on my existing cash flow and infrastructure. Additionally, I look for the opportunity for growth within the system, so it is important to understand the growth strategy and percentage of multi-unit operators currently in the system."

The first thing Harry Rose, the principal of the Rose Group, a multi-unit developer of Applebee's Restaurants, Johnny Carino's Italian Kitchen and Roy Rogers Restaurants, looks for in a new concept is the "economics of the box." Rose typically looks for investments with a cash on cash rate of return of 25-30%. If the economics work, Rose then analyzes whether the franchisor is committed to franchising as a means of future growth, as opposed to growth through company owned units. The former being much more appealing.

John Betz, a principal in Betz & Associates, a 12 Auntie Anne's developer and 3 unit licensee of Starbucks Coffee, considers earnings information critical in evaluating any additional development opportunity, especially when it involves a new concept. In more mature businesses, Betz analyzes traffic counts, lease costs and other variables to validate a concept regionally. However, says Betz "with new concepts, the track record of operating units is the only reliable means of evaluating the opportunity."

Jeff Higgins, General Counsel of J.D. Byrider Systems, Inc., a 135 unit franchisor of subprime automotive sales and finance businesses, sees earnings claims as an indispensable part of any sales process intended to attract multi-unit operators from other

brands with existing infrastructure, access to capital and business experience. According to Higgins, "by giving these operators the information they need in the form they want, we have been able to shorten the sales process and accelerate the ultimate purchasing decision in a legal and proper manner."

According to Mort Aronson, former General Counsel to 6C, Inc., the franchisor of the Holiday Inn Hotel System, "earnings claims in the hotel industry as well as other industries are meaningful and helpful in selling franchises as well as affording franchisees valuable information in deciding whether to invest in a franchise. Unfortunately some franchisees are overly concerned in making earnings claims due to their perception of significant liability exposure. Earnings claims done properly are a significant plus to both franchisors and franchisees."

Since there are no exemptions from coverage under the FTC Rule for large multi-unit developers of any size, the only means by which franchisors can channel this information about "unit economics" to developers is through the use of an earnings claim, which meets all of the legal requirements of Item 19.

Despite the fact that many franchisors are actively and aggressively pursuing existing developers, according to FranData, only 12-13% of all franchisors include Item 19 earning information in their UFOC. So why, if franchisors have identified this very lucrative market of prospects, are so few of them creating an offering circular which contemplates their number one question?

In 1995, the FTC amended Item 19 to make it easier for franchisors to make earnings claims. By eliminating the requirement that a franchisor have a "substantial number of units" in order to make an earnings claim, the regulators intended to allow people to rely on available data to make earnings claims. Based on my review of a large compilation of Earnings Claims, despite the fact that Item 19 would permit franchisors to cast multiple unit data apart from single unit data, only The Sports Section in Georgia and Conroys/1800Flowers.com in California include a form of multiple unit earnings claim in their Item 19 disclosure. Eileen Harris Brooks, National Franchising Director of Conroy's/1800Flowers.com, says "clear communications and expectations are essential in successful relationships with franchisees. Earnings claims help manage a franchisee's financial expectations. If you are seeking sophisticated multi-unit buyers, providing multi-unit earnings claim information is essential in assisting the buyer with their decision. Implementing such practices demonstrates your organization's attentiveness to the importance of their business."

Moreover, depending on the type of unit to be operated by a multi-unit developer, (by way of size, layout, location, etc.) you can essentially breakout and create sub-categories designed to highlight the performance for each type of unit. For example, Cousins' Subs shows all of the combined results for all Cousins' operations overall, and then breaks out results between "Original Concept stores" and "Highly Efficient Concept Stores". This allows Cousins to "highlight" the earnings performance for their updated version of their concept.

Even franchisors with short operating histories, or those who have operated "modified concept" stores for a short period of time, like Mr. Handyman or 1-800- Dry-Clean, disclose sales results on a weekly basis, to demonstrate a trend toward higher annual gross sales in such units.

Even companies with few franchisees, like It's A Grind coffee company, present historical data of company operations with appropriate disclosures.

In most earnings claims, franchisors attempt to "normalize" gross sales data by eliminating units which have not been open for a prescribed amount of time (described in terms of months or years, or in terms of ramping or non-ramping and further segregated into media efficient vs. inefficient markets, A vs. B Mall locations, or leveraged vs. non leveraged).

With respect to cost information, which will be extremely important to prospective developers, most systems do not collect cost data the way that they collect revenue data. Many franchisors have made costs estimates expressed in dollars or as a percentage of sales based on company store performance or franchisee cost surveys, many with response rates of less than 15% of the system, in demonstrating a historical cost or gross profit margin for the business.

Of course, certain industries have embraced earnings claims, and particular measures of volume, occupancy or other economic industry benchmarks. If you are a hotel franchisor approaching successful hotel area developers, you should certainly have occupancy and rental information available and presented in your UFOC.

Other Changes to The Standard Approach

If you're looking for other instructive advice on how to approach an existing area developer, don't overstate the number of units which are open or in development. Developers know all of the vagaries which affect full performance under a development obligation and can distinguish between units which are being developed by area operators verses those which must be resold prior to opening. Next, don't approach the entire United States with a single development formula. Recognize the unique demographics of specific markets, including the ones that your prospective developers are operating in, when modifying your standard territorial allocation. Recognize that different channels of distribution may require modified versions of your concept. Lastly, treat experienced operators with the respect they have earned. Don't give them your standard five-page franchise application that you use to qualify single-unit operators. Rather, pull the Dun & Bradstreet or other financial reports on your prospects, and request financial statements in order to determine qualification.