Area Developer

2008 Multi unit Franchising Conference

MU101 – INTRODUCTION TO MULTI UNIT FRANCHISING

INTRODUCTION

According to the IFA Educational Foundation-FranData Research, Profile of Franchising released last year, franchising is booming. As a result of the continued expansion of existing brands, new brands entering existing industries and more companies in non traditional industries using the franchise business model, each fueled by the expansion of multi unit franchisee operations, franchising is booming. In fact, the one most prevalent phenomenon is the proliferation of multi unit franchise operators in many industries, particularly food. Today, nearly half of all franchised units are controlled by multi unit operators.

FACTS AND FIGURES

According to FranData research, 82% of all franchisees are single unit operators controlling 51% of all franchised units. Another 15% of all franchisees own between 2 and 5 units who control 24% of all franchised units but most significantly, 3% of all franchisees own more than 5 units but they control 24% of all franchised units. Combined, 18% of all franchised units control nearly 50% of all units and 43% of all multi unit franchisees are in the fast food industry, and 59% of all franchisees in the fast food industries are multi unit franchisees.

The emergence and growth of multi unit franchisees is having a profound affect on franchising, it is rapidly changing prospective franchisee screening standards, the quality and substance of existing training and operational support, pressuring franchisors to make financial performance representations in their franchise disclosure documents, and affecting the way contracts are written, by redefining “non-negotiable” rights and deal breakers.

Module I – Multi Unit Operation

Most franchisors initially experiment with operating multiple company owned locations, before even beginning franchising. Once a company decides to franchise, rights to operate multiple units often take the form of option agreements or rights of first refusal which appear as amendments to single unit agreements.

There are 3 principal methods of multi unit expansion prevalent in the US, although there are far more terms used to describe these relationships. The most traditional form of multi unit expansion occurs between two parties, the franchisor who licenses its marks and systems, on the one hand, and the multi unit franchisee, which operates the units, on the other. The other methods of multi unit expansion, namely subfranchising and area representation, all involve third parties, who will be recruited to operate the actual units. Area developer, which is the term most people like to call themselves, is used to describe all of these relationships. In this paper, the following terms will be used to describe the party who enters the relationship with the franchisor:

1) Multi Unit Franchisee. A multi unit franchisee is granted an exclusive or nonexclusive right to open a pre determined number of units in a defined or geographic territory on an agreed upon development schedule. A multi branded franchisee is a multi unit franchisee who operates units in more than one brand, from related or unrelated franchisors.

2) Sub franchisor. A Sub franchisor licenses the rights to act as the franchisor in a specified territory, and recruits franchisees to enter into individual franchise agreements directly with them, and then services and supports them pursuant to those franchise agreement. The sub franchisor must satisfy any regulatory compliance obligations, including any registration requirements. Subfranchising is used in practice less frequently in domestic transactions, except perhaps in the janitorial or other service industries.

3) Area Representative. An area representative or development agent as they are sometimes called, pays an initial fee for the right to recruit prospective franchisees in a particular area pursuant to a development schedule, and is usually responsible for performing certain of the franchisor's pre-opening and ongoing service and support obligations under the franchise agreement. A multi branded area representative represents multiple non-competing brands, usually through a single entity.

Both a sub franchisor and area representative usually pay an initial fee to the franchisor in exchange for a portion of initial franchise fees and royalties collected from franchisees in the area, but when a franchisor uses an area representative strategy, the franchisee enters into the franchise agreement directly with the franchisor, who collects all fees and is contractually responsible for providing all service and support

The Emergence of Multi Branded Franchisees

Over the last 10 years multi unit franchisees have enjoyed tremendous success, initially in single brands. A successful multi unit franchisee will no doubt have a sophisticated team of real estate and construction professionals engaged in the development process. As each unit opens, the developer comes closer to satisfying its development obligation or saturation point in the market. At the same time, there have been a proliferation of new opportunities and rapid expansion by other non competing well known brands, each of whom are seeking to leverage existing multi unit operators' personnel, financial resources and knowledge of the local market to grow their concepts. When developing units for an additional brand, multi unit franchisees need to look at all of their existing franchise agreements and ensure that the proposed development is in compliance with any in term restrictive covenant prohibiting the operation of a competing business during the term of any franchise agreement, "best efforts" and confidentiality provisions, and make sure that any proprietary information including any training manuals are protected from unauthorized disclosure to an unaffiliated brand. A franchisee must also consider whether moving forward with an unaffiliated brand will jeopardize any opportunities for expansion with their present franchisors. Remember that conflicting obligations can arise in the future, when a proposed new product line is in conflict with an in term restrictive covenant of one brand, especially when coupled with a duty to carry all products.

In the same manner in which multi unit franchisees are increasingly becoming multi branded, and as more examples of a successful expansion using an area representation strategy emerge, we have and will continue to see the establishment and growth of multi branded area representatives. A successful area representative can deploy its existing recruitment infrastructure, and knowledge concerning real estate and operations, and apply them to other non competing brands. The stronger the organization the more bargaining leverage these existing area representatives have. Because these multi branded area representatives typically want to administer all of their brands through a single organization, franchisors are increasingly being forced to consider non-exclusive relationships and the terms of their existing area representative agreements define those functions which must be separate. For example, based on the risk of prospects migrating from one brand to another, many franchisors seek to mitigate that risk by controlling the telephone number and websites used by the area representative to obtain leads for the franchisor. Sometimes, individuals are designated as brand managers and they receive all training and their activities are confined to the particular franchise. As more franchisors want to harness the strength of these individuals, you will find many former "non-negotiables," become negotiable in this context.

<u>Benefits of Multi Unit Franchising</u>

These expansion techniques are species of multiple unit franchising which share the common goal to open more units faster, to leverage a franchisee's money and personnel and to obtain a local presence.

From a franchisor's perspective, multiple unit franchising provides opportunities for accelerated growth, a vehicle to penetrate new markets, capitalize on certain market efficiencies, reduce the training, opening operational assistance typically provided to single unit franchisees and a means to attract and reward productive franchisees, as well as a means for liquidity for performing or under performing units.

By creating a growth vehicle for multi unit franchisees, there often results a loss of control. Franchisors are forced to deal with defaults differently, because the franchisor's interest in enforcing compliance, are tempered by its reliance on the franchisees ongoing royalties and validation. Moreover, depending on the discounts afforded to multi unit operators or the consideration paid to area representatives, these relationships can severely impair a franchisor's cash flow.

While multiple unit franchising is the clear trend, particularly in food, it is not appropriate for all opportunities. Sometimes it is a function of timing, as many new franchisors use various forms of multi unit franchising to grow in early stages, or in other cases the unit economics simply will not support the additional layers of infrastructure to make the investment worthwhile, in other cases multi unit expansion is at odds with corporate philosophy, or the lack of expansion capital in a particular industry or for other reasons.

Most prospective multi unit franchisees will tell you that they look for new franchisors with experienced management, strong unit economics, a successful multi unit history, and appropriate infrastructure (including personnel necessary to support multi unit operations), a strong brand and recognized marks, some level of integrated supply chain management, and a reputation for enforcing system standards.

On the other hand, franchisors evaluate many of the same attributes in qualifying a prospective multi unit franchisee. Franchisors try to identify individuals or groups with strong management, a successful history of multi unit operations, experience in the underlying industry and who have a reputation of vigilantly enforcing systems standards at their own locations, have demonstrated a history of compliance in their other franchise relationships, and are financially qualified. With respect to a multi unit franchisees available infrastructure, it is important to have a personnel development plan identifying when you intend to add key personnel.

Multi Unit Franchisee /Area Representative Recruitment

Recruiting Franchisees from Within

The first place most systems look for unit growth are existing multi unit operators. In mature systems, more than 50% of annual growth comes from existing franchisees. In growing your existing network, it is critical that you develop defined and measurable expansion criteria by which you can evaluate new opportunities and partners. In fact, the biggest challenge is that your franchisees have become the best prospects for other franchisors and if you are not in tune with your franchisees expansion capabilities and aspirations, then you may find them pursuing other opportunities. As multi unit operators from other brands join your systems, it will become more and more difficult to really assess the operator’s qualifications because you may not have access to accurate asset and liability information, compliance history, or be able to accurately quantify the commitments to an existing franchisor. Do not let the excitement of being wanted cause you to ignore the obvious. Beware of the franchisee with no business plan or apparent capacity. Make sure your units are not being used to fix a system that is already broken for a failed relationship with another franchisor.

How do you recruit new multi unit franchisees and area representatives? Certainly events like the Multi Unit Conference, and industry trade publications like Area Developer are a good place to start. There are some lists, like the list of Multi Unit Food Service Operators which exist of restaurant operators. But, these experienced operators don’t look for new opportunities on line, or at trade shows, so you have to get more creative. Some franchisors mail to lists of franchisees from non competitive franchisors which they buy from companies like FranData. Others work the network with businessmen or professionals who themselves represent or do business with your prospects, like attorneys, accountants, lenders, landlords and real estate brokers. Some companies have had success selling multi units through business brokers and referral networks. When you ask multi branded franchisees how they learned about their latest brand, most say they heard about it from an existing franchisee, and that kind of buzz about your brand is difficult to purchase. Most will acknowledge that they can be reached through public relations and articles in newspapers. Some start as customers, when something about your products or operations catches their interest. The only thing for sure is that more you know about your potential prospect's research process, the easier it will be target and reach them.

<u>Key Deal Points – Area Development Agreement</u>

Because the transactions are inherently similar, there are certain terms common to multi unit in the area representative agreements. The purpose of any multi unit development agreement is to identify the timing within which single unit agreements must be executed, or single units must be opened, area within which the development activities will be undertaken and the cost of such rights. Any proposed development should be consistent with the franchisors development plan in terms of geography so that the franchisee can be properly trained, units can be properly supported and supplied by the existing distribution network. The proposed area should have sufficient population and similar demographic characteristics to other areas where the brand has been successful and be transportationally efficient in terms of the drive time between units.

The development obligation is typically expressed in terms of numbers of units usually within a defined area, which can be exclusive or non-exclusive. Even franchisors who award exclusive development areas typically exclude non-traditional venues like airports, train stations, national accounts, internet mail order sales and other rights from any territorial grant.

Of course, the size of the development area should be considered in the context of the speed within which the franchisee must develop it. A larger territory will almost always require you to develop more units at a faster rate, but there are limitations on financial and human resources that limit the number of units which can profitably be opened and operated at one time. Agreeing to an unrealistic development schedule puts the franchisees initial investment in the territory at risk. Moreover, a savvy multi unit franchisee will want to open and operate some number of units and validate the return or likely return on an investment before becoming obligated to build and operate more unsuccessful units. In other words, most will risk the up front fees paid to acquire the rights, in order to avoid foreseeable operating losses at the unit level.

In negotiating a development schedule while it does not appear that most franchisors require the multi unit franchisee prospect to demonstrate an ability to construct all units contemplated in the development schedule, the qualification should certainly be higher than that applied to single unit applicants.

Development fees for multi unit rights are all over the board as are the terms under which they are paid. The starting point is the initial single unit franchise fee multiplied by the number of units to be developed under the agreement. Larger more mature franchisors typically do not award territories, but may discount the initial franchise fee for each unit in calculating the development fee. Most franchisors require this fee to be paid up front but a growing minority allow a portion of the fee to be paid upon the execution of individual franchise agreements. In systems which award territories, there is a real opportunity cost to not developing single units with third parties, and many franchisors believe that the multi unit franchisee should pay the full franchise fee.

Obviously, the actual agreement reached in any specific transaction will be a function of the relative bargaining power of the parties. As multi unit franchisees grow in size and sophistication, and in some cases are worth multiples of the franchisor, and the demand for their talents continues to increase, the paradigm is shifting along with the terms of “standard” agreements. Evidence of this shift is not only economic; in some cases multi unit franchisees or councils they form, have control or approval over the creation and placement of local advertising.

The development area and the development schedule should be negotiated with a clear understanding of the real estate requirements for single units and the competition for similar sites from other franchise and company owned branded outlets. Determine the availability of real estate meeting the franchisor’s selection criteria and understand that time delays associated with construction zoning changes and other administrative hurdles to new store development, before you agree to a schedule.

A good multi unit agreement will require the timely communication of important information, like progress on meeting development milestones. A good agreement might further require the timely delivery of business plans, infrastructure growth plans, or other matters directly bearing on the performance of the development obligation. A good agreement should explain the effects of closures on meeting the development schedule and some franchisors offer incentives to reward the franchisee for opening units early. With respect to training, the development agreement would speak to the specific multi unit training offered, over and above the training contemplated in the single unit franchise agreement. With the technology today, franchisors and operators can often obtain real time data of the economic performance of particular units, compare them to a sample, and identify deviations and “flag” atypical operating performance. The results of poor operations visits or mystery shopping visits are often reported or delivered instantaneously. A good multi unit franchisor will provide its operators access to the same tools it uses to oversee company or system wide performance, and train them how to use these tools to manage their portfolio of units.

A development agreement should spell out the circumstances under which the franchisor can declare a default, or terminate the agreement, but most often the default relates to the franchisee’s failure to meet the development schedule. In addition to the payment of any initial development fee, the multi unit franchisee’s principal obligations are to open and establish units on a schedule because it is a material part of the underlying consideration; most state termination statutes recognize that failure to meet your development schedule as “good cause” for termination.

While beyond the scope of this writing, a multi unit offer must be disclosed in the same manner as a single unit offer in either one or a separate Franchise Disclosure Document ("FDD').

Area Representation

Area representation is an interesting phenomenon. Early on, Subway, Mailboxes, Etc., Blimpies, Liberty Tax and others found that that they could subcontract the right to sell franchises and service and support their units to third parties, thereby implement a form of "decentralized" sales and servicing network which could accelerate growth as more feet on the street work to open units in local markets. In fact, many successful franchisors have been essentially capitalized on area representation fees, rather than debt or equity.

Assuming that a franchisee can be trained to render service at or near the level provided by the franchisor directly, then it would seem to boil down to a business decision really based on the prospect's own perception of the potential for unit growth and profits.

From a franchisor's prospective once the up front fee is spent, the franchisor has reduced its expected per unit cash flow by up to half, depending on the percentage due to the area representative. When the franchisor has no employees, the area representative provides needed cash flow and a vehicle to render services locally, but as the franchisor adds infrastructure, and achieves economies of scale, it could much more cheaply provide the services. Consequently, if you pledge half your initial fees and royalties to your area representatives, then you can expect the valuation of the franchisor to be roughly half of what it would have been in the absence of area representatives. The question is whether you make up in speed and development of the national market what you lose by granting someone an interest in your royalties.

In practice, area representatives in some systems have not performed, and franchisors have been forced to perform all of the obligations under the franchise agreement for half the fees. In addition, by essentially turning over the administration of your brand and marks to a third party who is not under your direct control expose the brand to various interpretations, especially if you are not closely monitoring each area representatives' compliance with system standards. The best approach is to move slow and try to be selective. Nail down your selection criteria and experiment, before you engineer a national roll out of an area representative program.

Once you determine to offer area representation agreements, many of the deal points are similar to those discussed in multi unit agreements. However, with area representation agreements particularly, franchisees believe they can open more units faster and in a larger territory, because, they only have to recruit third parties to meet these obligations. In determining an appropriate development schedule, you should determine how quickly other area representatives or the franchisor opened units in other parts of the country. Do not believe you can open more units or at a faster rate than other existing franchisees, unless you have some special skill set.

Initial fees under area representative agreements are calculated in a number of ways. Those which are based on population, typically charge a per capita fee of five to eleven cents per person to calculate up front fees. Many agreements provide for a split of royalties collected from franchisees in the area representative's territory between 30-50%. Some agreements incorporate a sliding commission scale depending on whether the lead is originated by the area representative, on the one hand, or franchisor or its broker network on the other. Most area representative agreements continue for a term of 10 years, but in many cases, the area representative's recruitment function expires earlier pursuant to the development schedule. It is important to delineate the specific functions which are delegated to the area representative in the area representative agreement. From a review of a sample of area rep agreements, it appears that franchisors delegate such things as: franchisee recruitment, or profiling, site selection and lease reviews, onsite training, ongoing service and support obligations, collections, administration of advertising funds and many require that area representatives conduct regional seminars quarterly management reviews and some require employment of a minimum number of support personnel for every x number of franchisees in the territory. Regardless of the detail or extent to which you delegate your obligations under a franchise agreement, a franchisor remains directly liable for providing the services to individual unit franchisees.

Area representatives are somewhat at the mercy of their franchisors. They are entirely dependent on its franchisors' timely performance of its regulatory compliance obligations and maintenance of an effective registration in franchise registration states, in order to legally be able to sell franchises. Fees are paid to franchisors and then to area representatives. Area Representatives can't directly enforce franchise agreements or collect fees in their own name, and are vulnerable to same defenses as arise against the franchisor. Moreover, their success may be impacted by events or disputes transpiring with other area representatives or franchisees, which create ugly litigation disclosures, or poor validation, based on matters entirely out of the area representative's control.

MODULE II – How do you achieve Operations Excellence using benchmarking?

It's difficult to imagine how far we have come in the past 30 years. Today, global competition is commonplace. Toyota is the largest automaker and this summer gas prices are expected to top $3.50 a gallon. The effects of consolidation are apparent in every industry; firms raised money to acquire market share rather than build it, and the result has been larger, fewer and better capitalized companies.

Information once available only on your desktop computer is now viewable available on any number of portable platforms, with increased access and mobility.

U.S. companies have been failed by using traditional target setting methods and have opened the doors to foreign and domestic competition. Only by establishing defined targets and implementing productivity programs based on industry best practices will a company become a superior performer. Benchmarking is a proactive and structured process to change operations in order to achieve superior performance by forcing managers to investigate internal and external industry best practices. By incorporating best practices into its operations, a company can reach its highest profitability and asset utilization. The purpose of benchmarking is to ensure a probability of success. In order to succeed at benchmarking, you must know the strengths and weaknesses of your own internal operations, be capable of identifying your points of differentiation from competitors, incorporate best practices from industry leaders and competitors and gain superiority by capitalizing on strengths and minimizing weaknesses. Benchmarking is sometimes divided into practices and metrics - the former identifying the methods used and the latter quantifying the effects of incorporating the practice. One cannot look at business metrics alone, but must understand the operating practices, which generate the business metrics. In order for the benchmarking process to be successful, it must be well communicated and embraced by all management.

In the franchising context, we typically think of benchmarking as it relates to identifying the best operators in the system, examining what makes them more successful, and teaching those methods to other system franchisees. If nothing else, a good franchisor generally knows the numbers. The first level of benchmarking involves sharing of information among members of the system, for companies that own more than one brand there are some practices, which have relevance to both competing and non-competing systems and can be shared across sister companies. Benchmarking has thus become a standard tool in the franchise industry, with franchisors and franchisees alike using it to measure and analyze their processes in hopes of increasing effectiveness and profitability. The goal of best practice benchmarking is to identify world-class performers and the specific underlying best practices they utilize that will enable an organization to realize similar world-class results.

Franchisors must also be able to benchmark the attractiveness of their offer against other franchise systems. Whether measuring operational performance or the system offering, benchmarking should also look beyond an industry to identify superior performance and thereafter benchmark functions so that these practices, processes and methods can be studied and documented.

In his book on benchmarking, Robert Camp defines benchmarking as follows: “Benchmarking is the continuous process of measuring products, services and practices against the toughest competitors with those companies recognized as industry leaders”, quoting David T. Kearns, CEO of Xerox. Benchmarking is commonly defined as “a systematic way to compare processes and practices in order to improve an organization’s performance.” Benchmarking is a continuous process of self-improvement. Each practice can be measured to quantify the size of the opportunity. However, benchmarking goes beyond metrics, and must determine what practices are being used to achieve these metrics. Benchmarking can be applied to basic products and services, or the processes used to manufacture the products. Benchmarking looks beyond direct product competitors to other industries to analyze what makes superior performers more successful. Benchmarking is an objective goal setting process. While benchmarks may take a number of years to attain they dictate the direction that must be pursued; rather than immediate gratification, success is realized over time. Benchmarking can study costs, customer satisfaction, after market service, and return on assets. In implementing any benchmarking plan, it is critically important to understand what information is to be benchmarked, to whom or what will it compare and how will the data be collected.

In 2005, the International Franchise Association (IFA) issued its latest "Financial Benchmarking Study" in 2005, which was designed to help franchisors evaluate their performance against others in the industry. The study presented aggregate data collected from IFA members to identify key performance indicators, and segmented the data into a number of relevant categories to provide profitability rankings. This study is an example of "competitive benchmarking," in that it enables franchisors to assess their advantages and disadvantages by comparing them with those of their direct competitors.

Since benchmarking is peer based, it is critical to ensure that all studied processes are the same. As you compare data and identify high performers, you can create benchmarking targets for underperformers. Generally, the first step is to obtain operational and management support for benchmark findings-hence the need to base them on real time and comparable substantive data. Findings can be "backed up" from other industry sources to bolster their credibility. These findings must then be translated into operational principles, which can be adopted and thereafter judged. Next these operational principles must be defined in terms of specific implementation actions, which are capable of periodic measurement, and subject to certain milestones for updating findings, based on the rate of change of such information. Finally, once these practices are fully integrated and institutionalized, the company is in a better position to achieve superiority.

When it comes to benchmarking, there is no one-size-fits-all model. Rather, the models employed by various franchise systems have proven to be quite different. In this article, we will explore the basic components of benchmarking such as data collection, use and analysis, and sharing of best practices—particularly within and across multiple brands.

Once you have determined your organization's goal in compiling benchmarking data and identified the pertinent data you will need, the next step is to implement processes and procedures that will facilitate data collection. Data collection methods can be manual, such as faxing or mailing pre-printed forms; semi-automated, such as e-mailing data or submitting it through an intranet; or completely automated, such as polling programs and dedicated web or PC applications. Manual data collection methods are the most burdensome, and therefore are typically limited to basic royalty, sales or similar data that is readily available. Semi-automated methods are slightly better, but are still time consuming, as they still require some manual entry. Automated methods, on the other hand, are optimal because they typically are cheaper to deploy once set up, require less skill to operate, and with web-based systems at least, are less dependent on the user's computer system. Furthermore, because they can process and background-transfer virtually any information inputted by the franchisees, they allow for more comprehensive data collection. It is important to keep in mind, however, to maximize the efficiency and effectiveness of *non*-web based automated systems, all franchisees must use a common software platform.

In order to benchmark performance within a single brand or across multiple brands, the first step is to identify and gather the pertinent data. When you are collecting data across multiple brands, you must balance the need to maintain specific brand identity with the goal of sharing potentially lucrative profit ideas.

You may collect data from various sources, whether it is from internal company documents, manuals, and websites—or external sources. Look outside of conventional outlets for information to benchmark. However, it is possible to collect too much information, which could be counterproductive to the objectives of benchmarking, and suffer from "paralysis by analysis." with an overload of information. For example, too often companies will chase data from external sources before they have done the necessary internal research that would make the data meaningful. In short, without a clear understanding of what type of data is particularly helpful to your organization and how it will be used, comparative data is meaningless. You can spend vast amounts of time scrutinizing massive amounts of external data instead of applying more limited information in a helpful manner. You must truly understand your organizational strengths, before you begin collecting comparative data. In addition, those involved in the benchmarking process within the franchisor organization need to be aligned on purpose and priorities; otherwise, you risk having participants pursue competing, and even conflicting, goals, almost insuring inefficiency and less than optimal results.

Another potential obstacle in gathering comparative data could be your own franchisees. If franchisees are not required under their franchise agreements to cooperate in your data collection efforts, they likely may resist cooperating because it is a time-consuming process that takes them away from their businesses. Before you can begin, you may have to spend considerable time and effort of your own just to get their buy in. Explain the need for their information and the utility of the compiled results in improving performance. If franchisees resist the publication of individual data, you can limit shared information to aggregate or compiled data. This information is critical to the multi unit operator and is an area where a franchisor can provide tremendous value.

Financial Performance Representations

If you are benchmarking, then you already collect and analyze the same data you need for a financial performance representation. I have long been a proponent of Item 19 earnings claims, but they are extraordinarily relevant to sophisticated multi unit franchisee recruitment. The fact is that existing multi unit franchisees and area representative candidates are so difficult to identify, that when you finally get their attention through whatever means, you have to give them some indication of how existing units perform. You can't expect them to make mom and pop validation calls.
Under the old and new FTC Rule, the only means by which franchisors can furnish earnings or gross profit information to prospects is in an Item 19 financial performance representation. Despite the fact that so many franchisors are actively pursuing existing developers, only a small fraction of the 20% of franchisors who make earnings claims, are actually presenting any multi unit earnings data.

By way of example, the attachment includes a collection of multi unit earnings claims, which make some reference to multi unit developers, or those operating multiple territories in their earnings claims. Companies like Mighty Distributing, 800-FLOWERS and Budget Blinds reflect multi-territory operation. The Sports Section presents data by type of plan, which is a way they identify territory size. Figaro's includes an earnings claim for its "area director" offering.

While the FTC has long regulated the provision of earnings information to prospects, the recently amended FTC Rule, which now refers to this information as "financial performance representations," defines them as:

> any representation, including any oral, written, or visual representation, to a prospective franchisee, including a representation in the general media, that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits, or net profits. The term includes a chart, table, or mathematical calculation that shows possible results based on a combination of variables. New FTC Rule Part 436.1(e)

A franchisor can always provide cost and expense information to prospect, but any actual earnings information for franchisee or company operated units or projections must have a reasonable basis and written substantiation for the representation at the time the representation is made and must state the representation in the Item 19 disclosure.

The franchisor must also disclose whether the representation is based on actual historic performance of all or an identified subset of units, or is a forecast of the prospective franchisee's future financial performance. Because there is a much higher contingent Liability associated with "projections" – because you are essentially making a representation about how well you think the prospect will do – most legal representations are based on historical operating performance of franchisee and for company owned units. If the representation relates to past performance of the franchise system's existing units, the FDD must state the material bases for the representation.

The representation must contain certain required warnings along with a statement that written substantiation for the financial performance representation will be made available to the prospect.

Whether the representation relates to the performance of all of the franchise system's existing outlets or only to a subset of outlets that share a particular set of characteristics (for example, geographic location, type of location (such as free standing vs. shopping center), degree of competition, length of time the outlets have operated, services or goods sold, services supplied by the franchisor, and whether the outlets are franchised or franchisor-owned or operated); (B) The dates when the reported level of financial performance was achieved; (C) The total number of outlets that existed in the relevant period and, if different, the number of outlets that had the described characteristics; (D) The number of outlets with the described characteristics whose actual financial performance data were used in arriving at the representation; (E) for those outlets whose data were used in arriving at the representation, the number and percent that actually attained or surpassed the stated results; and (F) Characteristics of the included outlets that may differ materially from those of the units offered to a prospect.

Representations are typically based on single unit performance, which in this context may be enough. But, if you are trying to attract multi unit operators and can demonstrate some efficiencies or other attributes which arise from multi unit operation and you have some existing successful multi unit operators, why would you not put it in your FDD and use it as a selling tool? If you are selling area representative territories and have some existing successful area representatives, you could profile fees earned, or speed of selling units or ramp up.

Significant Differences from the Old UFOC Guidelines

The New FTC Rule expressly permits a financial performance representation based on a subset of outlets that share a particular set of characteristics and limits disclosure of outlets which exceeded the stated result to only those outlets which were used in arriving at the representation. In the context of multi unit franchising, the New FTC Rule permits franchisors to highlight the performance of multi units, or mall stores, or in line stores, rather than all units. This allows you to present data from your top performers stating the number of franchisees in that subset which exceeded the average, rather than the percentage of the total system.

However, a franchisor still must have a reasonable basis and must disclose: (1) the nature of the universe of outlets; (2) the total number of outlets in the universe measured; (3) the number of outlets from the universe that was actually measured; and (4) any characteristics of the measured outlets that may differ materially from the outlet offered to the prospective franchisee (e.g., location, years in operation, franchisor-owned or franchisee-owned, and likely competition). Prospects can then assess for themselves what weight to give the financial performance representation.

Presenting a Financial Performance Representation

Normalizing Data

Financial Performance Representations can show sales, costs, profit or other industry specific measures of unit performance, and can be limited to units which have been open for some period of time, classified by state or region (including sub regions defined by advertising co-ops, or media efficient markets), type of unit (kiosk, inline, pad site or mall/food court), those of a particular size or shape (by building design or layout), or those units with a particular capacity (in terms number of seats, desks, customers or students), or units with a particular volume of business (in terms of the number of rooms, vehicles, students, or volume of checks cashed or any other measure of unit performance), or which have been open a particular length of time (which are sometimes defined as mature vs. ramping up), or which have been open during a recently concluded period (the last year). Claims can state the results of specific franchisee, company or affiliate owned units expressed in terms of averages or ranges, and report the results of multiple unit operators separately.

Obtaining the Information

Often the information collection process is an evolution. Once a franchisor determines what information to present, it can adopt reporting processes and procedures to collect and verify the data. Franchisors frequently fill in missing pieces of information by using a "survey". When using surveys or questionnaires, franchisors should err on the side of formality, and carefully document the franchisees' responses either by measuring responses against other reported data, requiring signatures on written surveys, or providing a written record of any data reported by telephone to the reporting franchisee.

Types of Financial Performance Representations

Gross Sales Representations

Hands down, the most commonly used form of earnings claim is a statement of gross sales. "Gross Sales" earnings claims are nothing more than an average of franchisee reported gross sales information. Most representations eliminate units which depress averages, like start up units or mature units, and categorize and present the results in the light most favorable to the current offering (by size, shape, or region).

Gross Profit Representations

Most representations disclose "gross profit," but the term "gross profit" is not generally used in the accounting or tax sense, but rather as a contractually defined calculation of gross sales, less certain defined expenses, like labor, occupancy costs, raw materials, debt service, or similar expenses. The franchisee is generally left to extract its own information for the remaining items of expenses, like the franchisee's own salary and benefits, which are not included in the calculation.

Special Industry Performance Standards

Over the years, certain specialized industry specific measures of unit performance have evolved. In the hotel industry, average room rates, and occupancy rates have long been disclosed by competing brands. In service businesses, including the automotive aftermarket, the volume of business is often expressed in terms of number of vehicles, number of jobs, gross profit per job and break-even gross profit per job. Restaurants often disclose food or labor costs, usually as a percentage of gross sales.

Measures of Productivity/Frequency

Representations can also be based on productivity, like (i) achievable work day per technician, (ii) average annual revenue per sales day, (iii) average of revenue per van or kiosk, (iv) average commissions or co-op advertising credits , (v) value of national accounts, (vi) sales closing rates, (vii) vacancy /occupancy rates and (viii) yield from a particular amount of product or service, or based on customer frequency, like (i) percentage of re-bookings, (ii) percentage repeat business, (iii) average backlog, (iv) average number of customers, or (v) average price per service.

Other information such as units necessary to achieve media efficiency, or a claim which analyzes the effect on Gross Sales for units adding new equipment, may demonstrate the cost effectiveness of making an additional investment in equipment or space.

Some information, like closing rates or average price per service, on their face does not appear to be a representation. However, if anyone during the sales process gives the prospect the additional piece of information of the average number of customers or average number of jobs, then the prospect can combine that data to form an illegal representation. The fact is that, along the way, information comes from many sources, and as a practical matter you are counting on the franchisee to separate what he learned from you, versus the information he learned from your existing franchisees. If you have a written representation containing this information, then there is an active barometer against which to measure the information obtained from within or outside of the organization.

Supplemental Financial Performance Representations

The biggest opportunity and most infrequently used tool to demonstrate multi unit performance is through a supplemental financial performance representation (formerly known as a supplemental earnings claim). If a franchisor furnishes financial performance information in compliance with the New FTC Rule, the franchisor may give a prospect supplemental financial performance representations about multi unit operators, or a particular location or variation, apart from the FDD. The supplemental representation must: (a) be in writing; (b) explain the departure from the financial performance representation in the disclosure document; (c) be prepared in accordance with the requirements of the new FTC Rule above; and (d) be furnished to the prospective franchisee.

A Prospective Franchisee's Use of a Financial Performance Representation

Prospective franchisees must be aware of what a franchisor's Item 19 financial performance representation is and what it is not. First, understand whether the representation is a projection or based on historical data. If it represents historical data, consider all of the material assumptions upon which the representation is predicated, what information is excluded, what units and time periods are covered. Try to understand ramp up, so you can better predict cash flow.

Next, is the data presented applicable to where and what you want to operate. For example, is the data limited to mall food courts in the Northeast but you want to operate an in line restaurant in California. If you are potentially the first franchisee to open a unit in New York City is the cost information provided for a system centered in a different geographic region reasonable or even relevant? Is the data limited to a particular type of operation (i.e. those of a certain square footage, equipment package, product offering) and is the data relevant to the type of franchise you want to operate.

Franchisees should also undertake their own due diligence and investigation before purchasing a franchise. Relying solely on the franchisor's representations and Item 19 disclosure is never a good idea. Item 20 of the franchise disclosure document provides the name and contact information of the franchisor's franchisees. Prospective multi unit franchisees should also ask which franchisees own more than one unit and which franchisees are similarly situated to them. Nevertheless, prospective franchisees should call every franchisee on the list and ask about their experience, and verify any financial information provided by the franchisor and confirm the accuracy of their own business plans. If you are agreeing to open units on a development schedule, talk to other multi unit franchisees or area representatives and see if they are able to stay in compliance with their development schedule, if they obtain promised support and if they would do it again, if given the opportunity.

Exemptions under the New FTC Rule

Existing Outlet for Sale

If a franchisor wishes to disclose only the actual operating results for a specific outlet being offered for sale, it need not comply with the Item 19 requirements, provided the information is given only to potential purchasers of that outlet.

Sophisticated Investor Exemptions

The New FTC Rule creates three exemptions, collectively referred to as the "sophisticated investor exemptions": (1) the large investment exemption; (2) the large franchisee exemption; and (3) an exemption for franchisor officers, owners and managers. In creating these exemptions, the FTC acknowledged that "franchising today often involves heavily-negotiated, multi-million dollar deals between franchisors and highly sophisticated individuals and corporate franchisees with competent counsel." In the course of such deals, prospective franchisees often demand and obtain material information from the franchisor that equals or exceeds the FTC's disclosure requirements.

The New FTC Rule exempts franchise sales where the prospective franchisee makes an initial investment totaling at least $1 million, excluding the cost of unimproved land. To ensure that the large investment exemption is not overly broad and does not create a loophole, the FTC has required additional safeguards beyond the $1 million threshold to protect the average investor. First, the funds obtained from the franchisor (or an affiliate) cannot be counted toward the monetary threshold. Second, franchisees must sign an acknowledgement that the sale is exempt because the franchisee will be making an initial investment of at least $1 million.

Next, the New FTC Rule exempts transactions in which the franchisee (or its parent or any affiliates) is an entity that has been in business for at least 5-years and has a net worth of $5 million. Note that this exemption only covers "entities" and sales to individuals, no matter how wealthy, are not exempt under this exemption.

Lastly, the New FTC Rule exempts franchise sales to officers, owners and managers of a franchisor. The FTC recognized that in these circumstances it was likely that prospective franchisee already is familiar with the business and risks. To qualify for the exemption, one or more purchases of at least a 50% ownership interest in the franchise; within 60-days of the sale, has been, for at least 2-years, an officer, director, general partner, individual with management responsibility for the offer and sale of the franchisor's franchises or the administrator of the franchised network; or within 60-days of the sale, has been, for at least 2-years, an owner of at least a 25% interest in the franchisor.

Under the New FTC Rule, the FTC will adjust the monetary thresholds for the exemptions every fourth year based on the Department of Labor's Consumer Price Index.

States with Franchise Registration Laws

Generally, those states which require pre-sale registration of the franchise disclosure document do not recognize the sophisticated franchisee exemptions. Those states that do, such as California, Maryland and New York which recognize in some form sophisticated or experienced franchisee exemptions, require that the franchisor file for and be approved for the exemption.