The Disadvantages of Franchising

The hype surrounding franchising can be so seductive that it causes executives considering the option to abandon all semblance of logical evaluation for the promised glory and increased profits. Attending a franchising seminar is like a cheerleading talent show, with presenters offering up frenzied accounts of wild success while asking inane questions about the audience's interest in success. All of this serves to obstruct the view to one huge wall of doubt that should at least initially cast on any decision to franchise.

There is no doubt that under the right circumstances franchising is an excellent strategy that makes a great deal of sense and should be pursued aggressively. Under these situations the downside of franchising is well outweighed by the advantages. It is these advantages that are getting all the attention, while the disadvantages are somehow swept under the rug for people to discover through their own investigation – or worse their own experience.

Tudog doesn't work that way. We believe that every possible disadvantage needs to be known and understood before a strategy is selected. The attractiveness of advantages notwithstanding, it is the disadvantages that cause the problems and can turn a potentially successful venture into a resounding failure.

Therefore, the recent discussion in these pages on franchising and the value it can bring to an enterprise is hereby offset, or at least put into perspective, with this discussion of the very real and potentially disastrous disadvantages of franchising.

1. **Goal Conflict** – franchising causes a natural conflict of interests between franchisor and franchisee, stemming from the way each makes money. The franchisee makes money by deploying the franchise system and serving customers – from which payment is extracted. This means that the franchisee wants to serve as many customers as possible using the franchise system, which in turn means that they want as few others as possible using the franchise system in or around the area from which they hope to attract and serve customers. On the other hand, the franchisor makes money by selling as many franchises as possible, even if that means that the average revenue of each franchised unit goes down. So the franchisor may, and often does, sell multiple franchise units in areas where fewer units would mean more sales per unit. This cuts down on the money each franchisee makes, causing conflict – and often leading to litigation – between franchisee and franchisor.

2. **Inherent Disincentives** – the franchise system has inherent disincentives built into its structure. The nature of the system does not necessarily encourage individual franchisees to adhere to every aspect of the franchisors system, particularly those parts of the system that cost him/her money but bring very little return. While there are guidelines set out in the Franchise Agreement that requires adherence to most aspects of the franchisor's operations, some elements cannot be defined and others cannot be controlled. These are the elements that the franchisee, not out of malice but rather out of an attempt to make as much money as possible, will ignore or pay less attention to. The more franchise units you have in your area, the more likely this is going to occur. For example, a franchisee might not market as aggressively as he/she ordinarily would if there are other local franchisees doing marketing. The franchisee might, probably correctly, conclude that the brand is getting exposure and he/she will get increased traffic based on the activities (and dollars) of others. So, rather than add to the

momentum and market as well, he/she actually has an incentive to do nothing and enjoy the benefit derived from the actions and money of others.

3. **Difficult Environment for Innovations and Change** – the franchisee is often uninterested and unwilling to participate in franchisor initiatives because they do not always serve his/her interests. It is because of this that the all too familiar "available at participating locations" has come into our lexicon. The franchisees who elect not to participate have concluded that the discount the program requires they offer does not make sense for their particular unit, even though it may make sense for the chain. Similarly, when a franchisor wishes to introduce a new product there might be franchisees who decline because of the new equipment that might be required or the new inventory that might need to be carried. The inability of the franchisor to require participation severely weakens the franchise model and opens up for inconsistencies in the marketplace.

4. **Lower Financial Returns** – while franchising is a cheaper and accelerated way to open up many outlets, it is not necessarily the most profitable way. It is necessary to keep in mind that the trade-off for not having to spend any money to open the unit (and in fact getting paid by someone else for the right to do so) is that at best you will see approximately 4% - 10% of the gross revenue. In businesses that carry 20% or higher gross profit rates, settling for 4% - 10% is quite a reduction.

Franchising establishes a business relationship between two independent companies – the franchisor and the franchisee. This by definition creates two distinctive sets of interests, which by definition creates the opportunity for disagreement and issues. While franchising may still be the best alternative for your company to expand and grow rapidly, knowing these disadvantages can at least make sure you're not caught by surprise.