The contrarian

Franchising – aspiring entrepreneurs look away

The successful franchising companies tend to keep a strict control on their franchisees. So where's the excitement for a budding entrepreneur, asks Jon Entine

Control equals success for Hertz

We obsess a lot at Ethical Corporation about "big business" but the businesses that touch us every day are local shops. Many have international brand names on their signage, but are licensed and operated by our neighbours.

In the Middle Ages, kings granted rights to collect taxes, brew ale, or operate meat markets, collecting a royalty fee. Here are the modest roots of franchising, which began growing in the 1960s, after a hamburger shop named McDonald's in suburban Chicago started spreading its seed across America.

Today, it is estimated that the 767,000 franchised businesses in the US account for 45% of retail sales, generating $1.4 trillion in yearly revenue. The UK turnover of franchised businesses, £10 billion, is far smaller, but growing. And franchising is exploding in Asia, particularly China, India, and eastern Europe. Fornetti, the Hungarian-based baking company, is already Europe's third largest franchiser.

Huge growth has spawned an expanding market in franchising magazines and internet tout sites. Who hasn't heard the apocryphal story of the middle manager who opened up a sign shop or burger-flipping joint only to retire on a yacht in the Caribbean?

"The good news is that the likelihood of you failing as a franchisee is fairly remote," states "Business Opportunities", one of dozens of sites feeding the franchising frenzy. "According to the US Small Business Administration, roughly 30% of all non-franchise businesses fail within the first year." Articles invariably tout a 25-year-old study by the International Franchisee Association, claiming 95% of all franchises succeed.

Don't believe it

"Despite the hype that franchising is the safest way to go when starting a new business, the research just doesn't bear that out," says Timothy Bates, an economist at Wayne State University (Michigan). His analysis of 1,300 start-up businesses concluded that those without links to a parent franchiser generated higher profits with lower failure rates.

Another study, by Sloan (MIT) Management Review, found that by the third year the franchise failure rate begins to exceed the non-franchise rate mostly because money-losing franchisees who had hung onto failing businesses longer in a desperate attempt to recoup sizable start-up fees finally throw in the towel. "While it would be wrong to conclude that franchising opportunities across the board are poor, the likelihood of success is much dimmer than the industry would have us believe," Bates adds.

Frustrated middle managers and aspiring entrepreneurs are especially vulnerable to the gold-at-the-end-of-the-rainbow pitch. Potential buyers are steered to less costly franchises on the theory that there is less money on the line.

That's spurred growth in Subway, Curves, Chemex, Glassinter, and Signs Express – long-hour, low-return eateries, retail, service, and B-to-B shops. Many fast-expanding franchisers, including Express Personnel Services, Jani King cleaning, and Comfort Care in-home services, aggressively pitch themselves to minorities and women as safe, socially responsible chains.

Big brands best?

Yet, study after study has shown the safest bet is to buy into a big brand with a big media budget. That combination is usually found with franchisers that own a large percentage of their outlets, so they are more apt to risk their own money in advertising to lure customers.

For instance, the two car rental companies that spend big bucks marketing quality and service, Hertz and National, respectively own 66% and 40% of their sites. Thrifty, Alamo, and Dollar, which are almost totally franchised, spend little money on brand advertising, so it's no surprise their franchisees limp along as low service alternatives.

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And don't expect the government to protect you if revenue falls short of the "average franchise" noted in the offering documents. Even in the US, which has far more regulations than most other countries, it's almost impossible for aggrieved franchisees to sue for fraud. ■

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