Trends: Emerging Franchisors

An Examination of New Franchise Concepts

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2017 Franchise Small Business Report

An Examination of New Franchise Concepts

Source Material

All information in this report was compiled from FDDs received and registered by state franchise examiners, and survey responses. Franchisors are required under state and federal laws to produce and deliver FDDs to prospective franchisees. As part of this disclosure process, certain state regulatory agencies require complete and updated FDDs to be filed and approved before a franchisor is permitted to sell franchising rights within their jurisdictions. These documents must be accurate by law.

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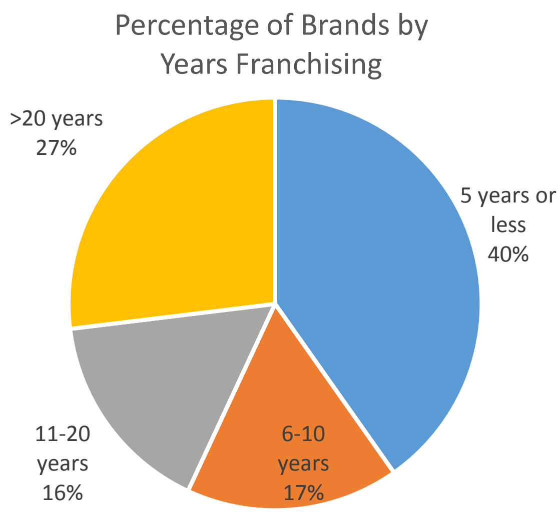
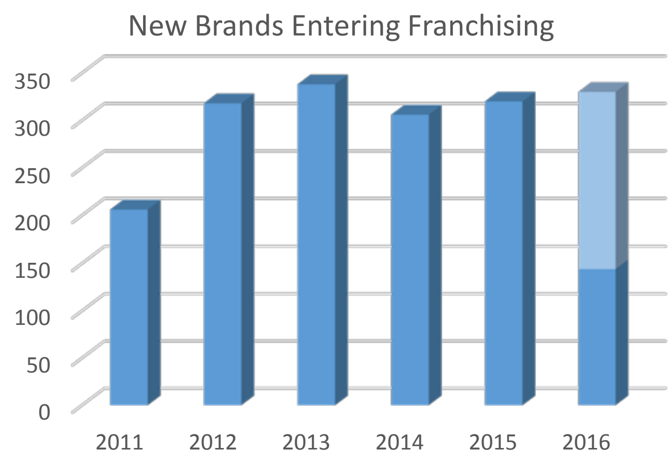
INTRODUCTION

The franchise industry is an innovative marketplace made-up of a wide and ever changing range of business concepts. New franchise brands appear in the market every day. They push the boundaries of industry and sector, they test new customer demand, and they take advantage of changing technology. While there are some notable exceptions, most of these brands – these concepts – have few existing units and very small corporate footprints.

Over 1,600+ brands have started franchising since 2011, with an average of 300 brands entering the market each year. That is 40% of all brands that were actively franchising during this period.





* projected numbers due to the lag in FDD collection

Looked at overall, these new brands cover the gamut of business types: 36% of emerging brands were food brands, mostly quick-service restaurants; 64% were nonfood and service brands. Verticals that saw a large amount of growth include the health and fitness industry, child-related products and service and general business related services. Each of these verticals grew by 50% the number of brands offering these types of products and services since 2011.

Most new franchisors are true start-up small businesses when they start franchising. The majority are entrepreneurs and small business owners who are taking their small business to the next level through the franchise business model. Of the 1,600 new brands that have started franchising since 2011, only 15% are established companies with big corporate backing, including international brands bringing their concepts to the US, established companies diversifying their portfolios and adding new brands, or companies with large corporate backing or private equity ownership.

This report focuses on the 85% of new brands that are true start-ups. The report tells the stories of these small business owners before they started franchising, and then examines their journeys and experiences as they grow through franchising. The research analyzes franchise system growth in the first five years of franchising, incorporating survey analysis and phone interviews that dig deeper into new franchisors' backgrounds, motivations, experiences, and challenges.

METHODOLOGY

The International Franchise Association (IFA) partnered with FRANdata to assess the characteristics, experiences and challenges of new and emerging franchisors. A combination of in-house data analysis, survey analysis, and qualitative phone interviews lead to the discovery of the major findings of this study.

FRANdata identified 1,600 brands that have started franchising since 2011 through their in-house database. FRANdata analyzed in-house data to establish a basis for the quantitative findings, including the first three years of unit patterns and growth (for both franchised and corporate owned units), unit openings, and details about the corporate structure of emerging franchisors. FRANdata and the IFA conducted a short online survey of new franchisors to drive and support the major findings. The survey analysis is based on the responses of 30 emerging franchisors that are representative of the overall franchise space based on industry distribution and year started franchising. Following up on the online survey, FRANdata conducted 12 phone interviews with emerging franchisors, digging deeper into their "start-up stories" to understand their experiences, motivations, and challenges. The major findings are supported by statistics derived from in-house data and the online survey, as well as anecdotal stories and quotes from phone surveys.

PART I: PRE-FRANCHISING STAGE

Before starting to franchise, most brands start as small businesses integral to their communities. New brands bring unique concepts often inspired by personal experience and their communities. With so many new brands entering the markets each year, markets are getting more and more saturated. New concepts have gotten creative, offering unique products and services. These new brands have found niche spaces within the existing crowds, often creating completely new sectors. This subsector specialization allows new brands to operate in spaces with less competition, offering specialized products and services, often targeting a specific consumer market.

EXAMPLE

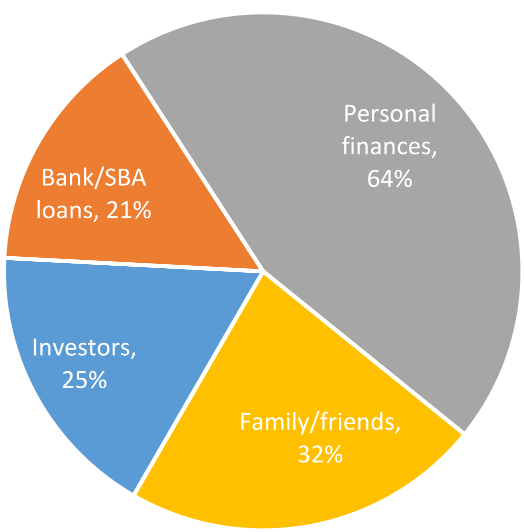
The first global farming franchise offering modular hydroponic greenhouse systems to the commercial grower and food service industry started offering franchises in 2011 after seven years of operation and two corporate units under their belt. The small business owner turned emerging franchisor wanted to spread locally grown, fresh produce globally. Franchising offered the unique opportunity to take the locally focused concept to a global level. These opportunities come with additional challenges of navigating previously unchartered territory. The concept of franchising was completely foreign to the agriculture community and the concept of farming was completely foreign to the franchise community. The emerging franchisor was stuck between the two, ultimately educating each audience on the unique business concept.

Many entrepreneurs are driven by passion when they start their first business, and our survey found that that same passion continues and grows as they start to franchise. It's not surprising that entrepreneurs have a passion for the products or services their business offers. While most small business owners start franchising because of the opportunities for fast expansion, with lower corporate overhead, and lower initial capital investment, new franchisors consistently referred to the importance of finding franchisees with passion for the business's products and services. New franchisors want to grow their business nationally or globally while maintaining a passionate culture that inspired them to first start their small business.

EXAMPLE

A husband and wife team started their independent home healthcare business after realizing there was a gap for in-home senior care services in their community. The couple got a call from an elderly neighbor asking if they could come by and bring her a meal while her daughter was out of town. When they got to the house, the poor old lady was bed ridden. She took their hand and almost on the verge of tears asked, "please don't leave me, I can't be here by myself." The couple, having no experience in the matter, ended up taking a week off from work to stay with and assist their elderly neighbor. A year later they decided to leave their jobs and start their home healthcare business. As they've grown to 20 franchised units, they still stress the importance of having compassion for people and for the services they provide.

Sources of Financing Used to Start Small Business*

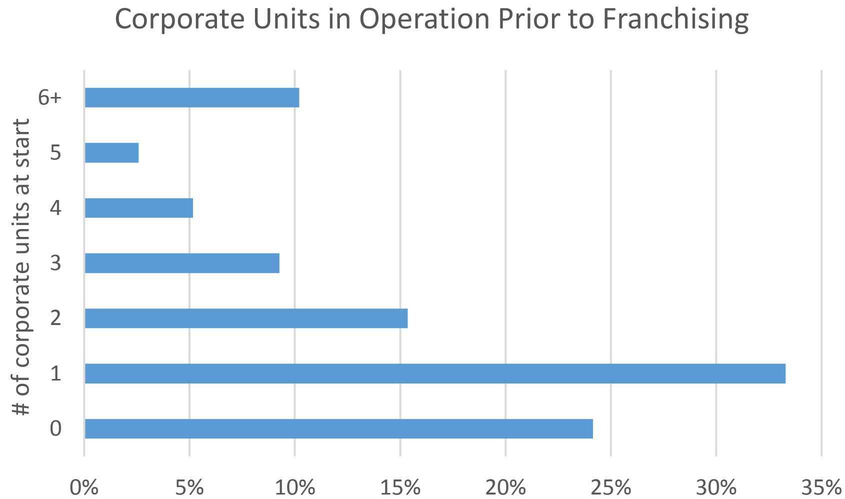


* survey respondents selected multiple responses

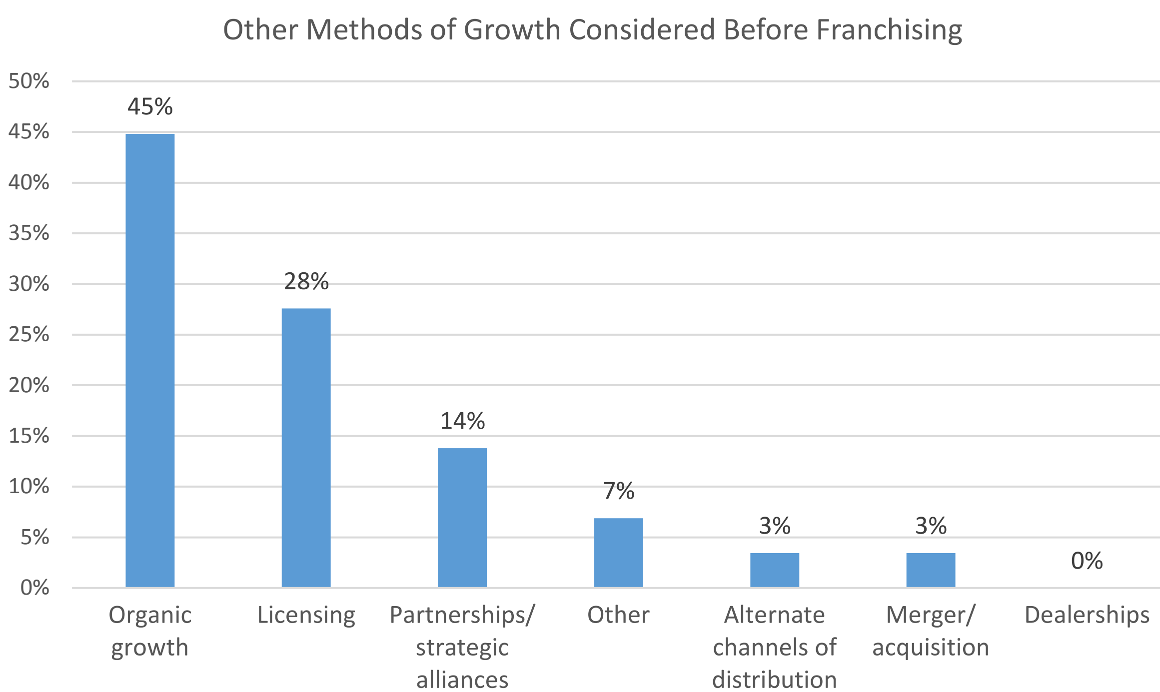
Almost all new franchisors use multiple sources of funding to finance their original business, with many digging into their own pockets and devoting everything they have to start their original independent business. Personal finances and loans from family and friends were the most commonly used sources to finance the start-up of the first independent business. Those two funding sources were used by the majority of new franchisees surveyed, who raised an average of $85,000 from their own pockets, and family and friends to invest in the start of their independent business.

PART II: FRANCHISE START PHASE

Small business owners have done their research and made informed decisions regarding their growth strategies. New franchisors have a median of one corporate unit in operation and were in business for an average of 10 years prior to franchising their concept.[1] New franchisors come to the market with a proven concept, having worked out all the kinks in their existing businesses prior to offering franchises.



When making the decision to grow their business, 60% considered other methods of growth including organic growth, licensing, and entering into partnerships or strategic alliances. In fact, many new franchisors tried other strategies, like licensing, before they ultimately moved to franchising. Small business owners come from many walks of life, some have extensive experience within the industry their business operates in, others with business backgrounds. However, most new franchisors don't have any experience with franchising prior to franchising their small businesses.



[1] The median is a more accurate depiction of the dataset than the average because a few outliers who started franchising with over 50 corporate units skew the average value.

PART III: EARLY FRANCHISING STAGE

New franchisors are small companies with lean operations in their first few years franchising. New franchisors employed an average of 3.3 people who wear many different hats and serve multiple roles in their first years setting up their new franchise systems.

It takes many years for new franchisors to reach a stage of sustained profitability. Emerging franchisors often consider three phases in achieving financial stability. The first being breaking even, but more importantly, achieving initial profitability, and the third and true test of financial stability is achieving consistent and sustainable profitability.

On average, it took 2.25 years for new franchisors to break-even. There was a large variance between emerging franchisors, with some reaching profitability within the first few months, and others taking up to nine years. Almost all emerging franchisors reinvest all incoming revenues, whether from franchise fees, royalties or corporate store profits, back into developing their franchise system as they grow early on. Many who generate enough profits from their original small businesses invest those profits back into fueling the start-up and early growth of their new franchise system.

EXAMPLE

The discussion around break even isn't always clear cut for many emerging franchisors. For example, when two sisters started franchising their early childhood education concept after having experienced quick success, they found that you spend a lot of time and money upfront, but on an ongoing basis, there's little overhead. The sisters initially invested around $50,000- $60,000 to start their original independent business, which quickly became profitable in less than a year. Realizing that there was a great demand for their childhood education programs, they spent the following year and a half preparing their concept to be replicable, and reinvesting all of their profits into the development of the infrastructure and programs that their franchise system would be based on. Both sisters invested all of their personal savings from over 20 years each in their respective careers towards both the start-up of their independent business and then the development of their franchise system. Neither sister took a salary for their first five years in business and every dollar of profits from the corporate business was reinvested into developing their childcare programs and supporting their new franchise system.

Emerging franchisors face many challenges when they start franchising, one of their top challenges is franchise development. Emerging franchisors are often still struggling to achieve and support steady growth in their first few years of franchising. New franchise systems grew at an average compound annual growth rate (CAGR)[2] of 28% in their first 3 years franchising.[3]

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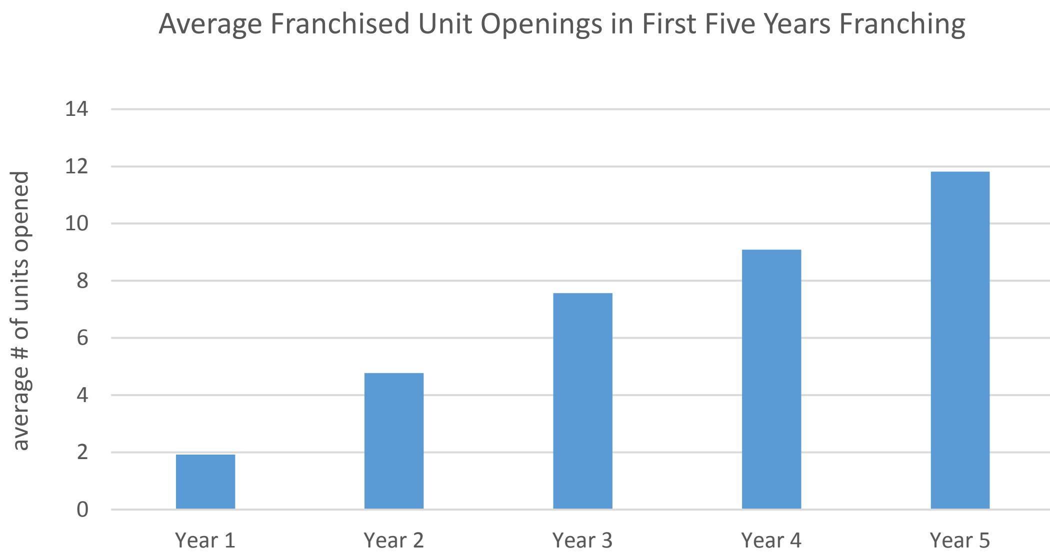
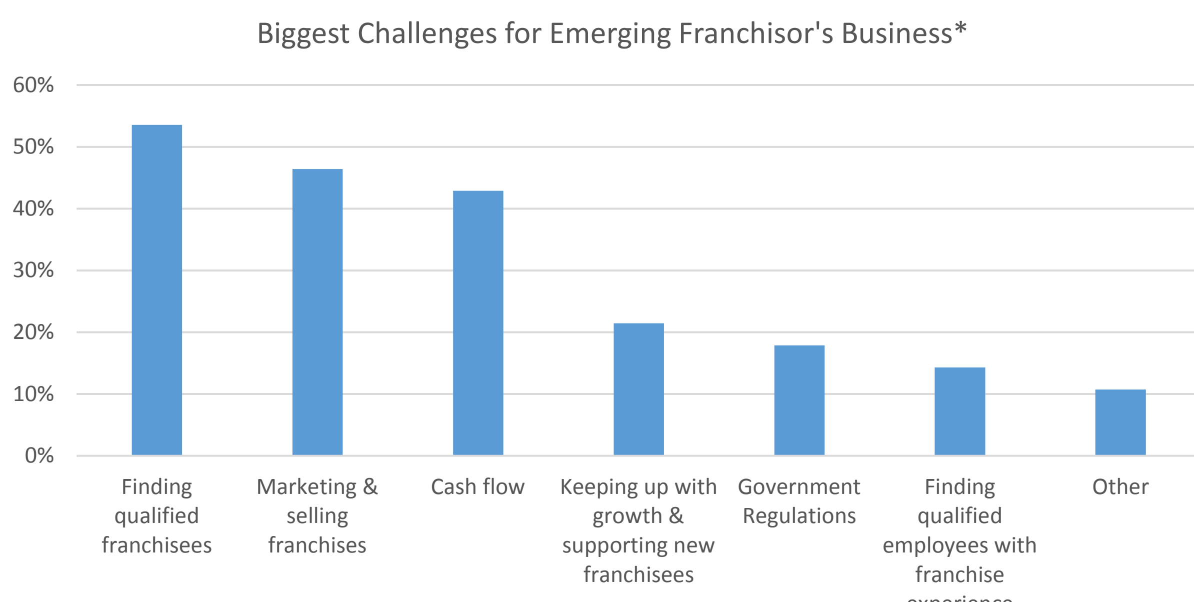
[2] The compound annual growth rate (CAGR) measures growth over more than one year-over-year periods. This looks at the change between the first and last year of the measurement period (year 1 of franchising, and year 3 of franchising), and smooths out the growth based on the number of years in the measurements period. Essentially, showing the average year-over-year growth for the examined period.

[3] Based on franchisors that started franchising between 2011 and 2013 that have 3 years of unit history to assess growth.

Emerging franchisors on average added two franchised units in their first year, more than doubling unit opening in their second year to opening 4.8 franchised units.



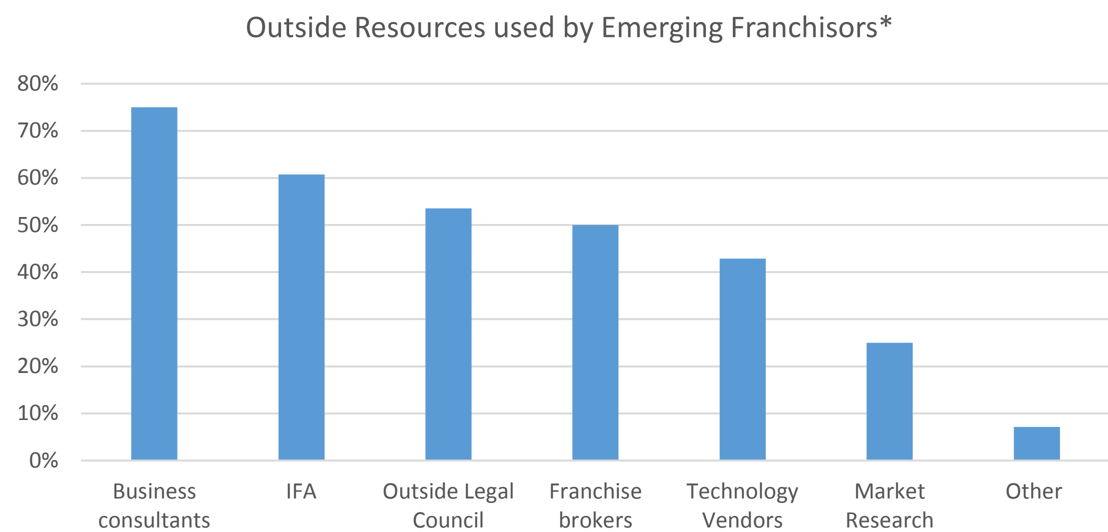
New franchisors named finding qualified franchisees, and marketing and selling franchises as their top challenges. Many are enlisting the services of franchise brokers to target franchisees, market to prospects, and help sell their first franchises. Emerging franchisors understand the importance of their first franchisees to the future success of their overall system.



* survey respondents selected multiple responses

While 75% of new franchisors don't have any experience in franchising, they take advantage of outside resources and the franchise community to help them through their challenges. New franchisors have found the franchise industry and experts within the industry to be a very welcoming community, willing to share their experiences and help mentor the next generation of franchisors.

Given their lean operations and tight budgets, emerging franchisors turn to outsourcing certain functions early on to allow them to focus on building the infrastructure to support franchise growth.



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CONCLUSION

Emerging franchisors start as small independent businesses filling gaps in their communities' needs, often investing their life savings, devoting their lives and passion into their small businesses. Once they make the decision to grow their business through franchising, they face a steep learning curve and many challenges. Emerging franchisors continue to reinvest every dollar their business makes to lay the infrastructure to support successful growth of their first franchisees. Emerging franchisors have found the franchise industry and franchise professionals to be a very welcoming, sharing their experiences and guiding them through their franchise journey. Given their experiences, motivations and challenges throughout the journey, more than 85% of emerging franchisors would recommend franchising as a model of expansion to other small business owners.

For more than 25 years, FRANdata has been the industry leader in the strategic analysis, forecasting and measuring of franchise performance and operations. Leveraging the largest database of franchise information in the industry, FRANdata helps any business that touches franchising by providing the objective information and analytical expertise they need to make smarter and better business decisions. FRANdata, headquartered in Arlington, Va., is often cited as a franchise expert in such leading media as The New York Times, The Wall Street Journal, Forbes Magazine and The Washington Post.

Powered by the FRANdata database, the Franchise Registry provides every franchisor the opportunity to make financing easier and better for their franchisees. Thousands of SBA and conventional lenders visit the site every month to find and learn about the franchise brands to whom they are considering lending. Besides publicly validating that a franchise is viable and thriving, the site allows franchisors to take advantage of such financing tools as SBA financing tools, Bank Credit Reports, Enhanced SBA Loan Performance Analysis, and the FUND report helping lenders understand and underwrite the franchise brand.

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