

The Changing Face of Franchising

Rupert M. Barkoff
New York Law Journal

August 28, 2017

Franchising has matured, but that does not mean that franchising will not continue to change. To appreciate this comment, one must take a trip in time back to the 1960s, when commercial franchising was in its formative years. Actually, modern franchising even goes back another decade or two with the growth of now legendary brands, such as McDonald's, Holiday Inns, Kentucky Fried Chicken and the like. In the 1950s, it is doubtful that anyone would have thought that 50 or so years later, these chains would become the behemoths we have today. A recent count showed there were 36,899 McDonald's restaurants and 44,588 Subways, each being systems that generate multi billions of dollars per year for their owners. Although Ray Kroc was certainly a man of vision, as portrayed in the recent movie, *The Founder*, did he ever imagine that the growth of the McDonalds system would be as great as it has been? The same could probably be said for the late Fred DeLuca, the founder of Subway.

Not only are there large restaurant systems, franchising is now being used in over 85 industries to create and distribute products and services. What is more, while franchising had its beginning as a method of delivering products to consumers, now it is used substantially to deliver services as well. But one must keep in mind that franchising is simply a method of distribution. Some people refer to it as an industry, but it is not.

Franchisees

While franchising has seen extraordinary growth, the franchisee population has changed as well. Back in the formative years, a typical franchisee would be an individual (usually male) who was looking for a way to become tomorrow's successful entrepreneur. With a combination of skills, training, methodology and capital supplied by the franchisor, and applying the techniques of a franchisor's system, many franchisees climbed up the ladder to success, in part because of their own work ethic, and in part because of the tools and teaching that a good franchisor provided.

Today, there are still the so-called Moms and Pops—those franchisees who want to start a business and need significant assistance and direction to achieve this objective. But in the last decade, we have also seen the entrance of multi-unit, and in some cases, multi-system franchisees. These franchisees are far from being the small entrepreneurs that the term "franchisee" envisions. Some franchisees have become companies with publicly traded equities, and others have grown through the use of private capital—the so-called private equity funds. There are many such companies that rival, and even surpass, the size of their franchisors. Some large franchisees have even become franchisors. It is a changing world.

What has this meant to franchising?

Large vs. Small

First of all, there are large franchisees and small franchisees in almost every sizeable chain with different needs, and the franchisors have had to modify their systems to accommodate both. The large franchisees have become more and more self-sufficient. They often provide their own

training to their employees and their managers. They individually have enough purchasing power to extract better prices from vendors. Additionally, in the field of advertising, they have opportunities of which many of the small franchisees can only dream of. Thus, since many of the services that franchisors typically provide are no longer in the province of the franchisor for the large franchisees, the franchisor must change its focus to accommodate not only these franchisee behemoths, but the fledgling and small franchisees.

Another difference between the large and small franchisees is that their long term goals differ. In days of old, many of the smaller franchisees envisioned their businesses as a means of growing an asset to pass down to their children. And in some chains that has been the result. There are, today, many franchisees in which, as the principals of these companies age, their children or other relatives assume the leadership of the family enterprises. Of course, there are some franchisees that have decided it is time to cash in their chips, so they sell out. This is often the way small franchisees become large franchisees, as existing franchisees gobble up franchises whose owners are ready to call it quits.

Changing Values

A key ingredient in the older franchise systems, which does not appear on any balance sheet, is the camaraderie of the old generation and their progeny. Years ago, when one attended a franchise system's annual convention, it was like going to a high school reunion. The conventions were more than just discussions of the business challenges facing a franchise system.

With the growth of professional management and the introduction of investors whose primary goal is to make money, values and business objectives have changed. In newer systems no longer is there a person who stands out as a figurehead for a franchise system. Is there a "Mrs. Massage Envy?" Who are the "Five Guys?" There are fewer Colonel Sanders and Papa John's today even though there are many more franchise systems. Instead, franchise systems are frequently run by professional businesspersons, who work not only to feed their families, but also to make wealth for their investors, who may be far removed from the franchise system's operations.

Long-Term Focus

On the other hand, the older generation of smaller franchisees are focused on the long-term. They want a business to pass on to their children two decades from now or to sell at retirement time. Accordingly, their franchise agreements provide long term commitments to the franchise system. In contrast, the new generation of quick growth franchisees concentrate on shorter time frames. While there are a few private equity funds, such as Roark Capital, who have held most of their franchise investments for longer than five years with no signs of bailing out, there are many franchisors that are only beloved by their investors on a quarterly basis. Such investors tend to modify their portfolios when the investment in the franchise is approaching or hits the five year mark. A side effect of this has been the creation of almost a secondary market in franchise systems, with the equity investment moving in and out of various franchise systems. As a result, the prospective franchisee must not place too much attention in the then-current management team, for it might be, Dairy Queen, more than just soft serve ice cream.

Enter Technology

And nowhere is change more affected than in the use of technology. The learning center model in educational systems used to be dependent on the personal contact between the students and their tutors. Today, tutors work out of their homes, and the students take lessons while sitting at home at their own computers. Such technological changes may even eliminate the need for an expensive bricks and mortar facility, or at least those of the size where tutoring has traditionally been done. But the benefit of personal face-to-face contact is lost.

The wise investment manager when asked how the stock market will do, responds, "It will fluctuate." This same statement can probably be applied to the environment for franchising. Who knows what tomorrow will bring?

Rupert M. Barkoff is chair of the franchise practice team for Kilpatrick Townsend & Stockton and a former chair of the American Bar Association's Forum on Franchising.

Reprinted with permission from the August 28, 2017 edition of the New York Law Journal® 2017 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. ALMReprints.com – 877-257-3382 - reprints@alm.com.