Economic Impact of Franchised Businesses

A Study for the International Franchise Association Educational Foundation

By the National Economic Consulting Practice of PricewaterhouseCoopers

PRICEWATERHOUSECOOPERS

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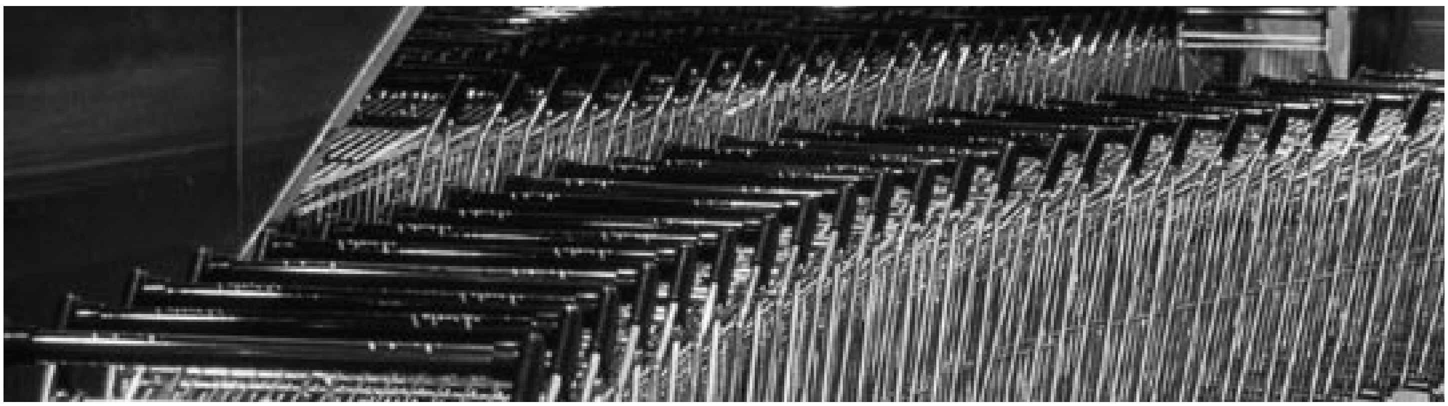

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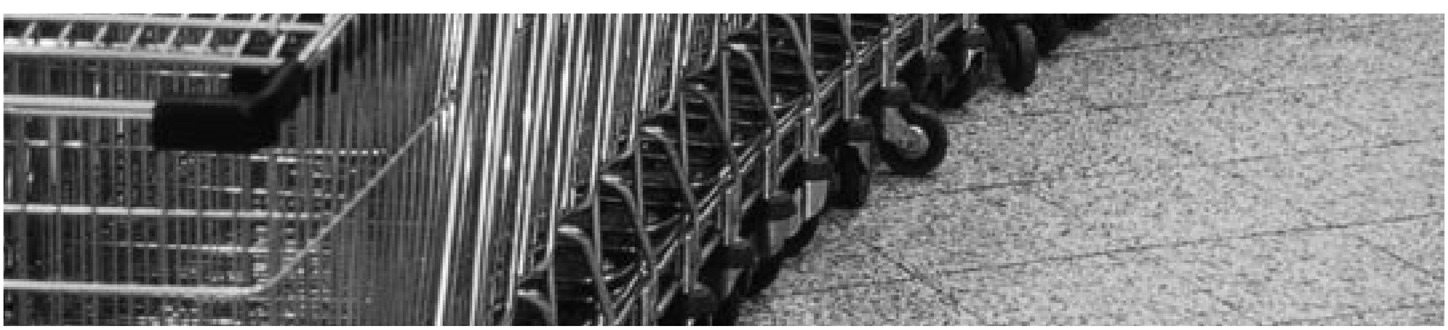

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Introduction & Acknowledgments

By IFA Educational Foundation

The *Franchising Economic Impact Study* is the largest, most comprehensive research project ever undertaken by the IFA Educational Foundation. We owe sincere thanks to many, many people for their commitment of resources, time, talent, and efforts to this project.

Many thanks to –

The IFA Board of Directors for the commitment of nearly $500,000 to underwrite the research effort.

The IFA Educational Foundation Board of Trustees for its commitment to this project.

To the Foundation's Research Advisory Committee chaired by Mike Isakson, President and COO, Franchise Services Group, The ServiceMaster Company, for guiding the research project.

To the IFA's Policy and Communications Advisory Committee chaired by Peter Cohen, President and COO, Sylvan Learning Systems Inc. for input on the media and distribution plans for the study.

To our dedicated staff in the Washington office, and in particular, to John Reynolds, President of the IFA Educational Foundation, and Kathryn Morgan, Director of Education and Research.

To the research team of the National Economic Consulting practice of PricewaterhouseCoopers in Washington; and in particular to Ken Wertz, Ed Mulrow, Steven Wilber, and Qiang Ma.

To the representatives of several government agencies, including the Census Bureau, the Bureau of Economic Analysis, the Department of Commerce, the Small Business Administration, and the Federal Trade Commission, who provided us with excellent feedback at briefings which took place during the research project.

To the IFA members who participated in the pilot survey and gave us valuable feedback on the complexities of gathering information about the operations of franchise systems.

To the many IFA members who took the time to provide us with detailed information about their system operations at the corporate and unit level. In particular, thanks to many IFA members who responded to a countless number of questions, followup phone calls, and emails.

This research project began with a simple idea – to do a study that would measure the economic activity of franchise businesses in the United States. The main purpose of this study is to educate people about franchising and the way franchise businesses contribute to the American economy. You will find these businesses at corner intersections, in shopping malls, in office buildings, and in every community in this country. It is time to count them and to document their importance to the U.S. economy.

In closing, I would like to add a personal note. While you will find this report filled with a wealth of statistics and numbers, it's important for us all to keep in mind that business is not about numbers, it's about people. It's people who invest their time, money, efforts and dreams to become a franchisor or a franchisee. It's people who work in our corporate offices and people who own, manage, and operate our businesses. It's millions of people who work for our suppliers providing the products and services that our businesses require. Every day it's millions and millions of people who go to work serving our customers around the world – and that's what franchising is all about.

Richard Rennick, CFE
Chairman, IFA Educational Foundation
CEO, American Leak Detection

ABOUT THE INTERNATIONAL FRANCHISE ASSOCIATION

Established in 1960, the International Franchise Association's (IFA) mission is to safeguard the business environment for franchising worldwide. It is the oldest and largest trade group representing those operating under this business model – some 30,000 franchisors, franchisees, suppliers, academics and franchise associations around the globe.

Franchising is a strategy proven to grow businesses quickly – a strategy used by some 75 industries to develop national brands since the 1940s when the current model of franchising began in the U.S. Hundreds of thousands of people have opened their own businesses by buying a franchise. They create thousands of jobs each year, help develop local economies, and provide vital opportunities for minorities and women. U.S. franchise concepts are being increasingly exported to other nations to help stimulate their economies.

IFA is the recognized "Voice of Franchising," and serves a key investor education role as well by offering seminars, books, videos and Internet-based courses to teach current and potential franchisors and franchisees about setting up or buying a franchise. IFA helped the Federal Trade Commission set guidelines for franchisors to provide vital information to prospective franchisees, established a Code of Ethics to which all members agree to adhere and endorses the National Franchise Mediation Program, which resolves disputes between franchisors and franchisees through less costly alternatives to litigation.

For more information about IFA, visit the website at www.franchise.org.

ABOUT THE IFA EDUCATIONAL FOUNDATION

The IFA Educational Foundation conducts research and educational programs to increase the awareness and understanding of franchising's role in the free enterprise system. The Foundation fosters education and professional development programs through the Institute of Certified Franchise Executives (ICFE). The Foundation provides scholarships to high school and college students and to veterans, and sponsors diversity training and minority outreach programs, through the generous support of many IFA members.

The Foundation encourages research by providing an annual award for the best applied research paper in franchising through the generous support of the Arthur S. Karp Family Foundation.

The Foundation, founded in 1983, is a 501 (c)(3) non-profit organization and all donations are tax deductible. The Foundation is supported through the generous contributions of IFA members and others.

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ABOUT FRANCHISING

Webster's Dictionary defines "franchise" as — "1. A privilege or right granted a person or a group by a government, state, or sovereign. 2. Authorization granted by a manufacturer to a distributor or dealer to sell his products." The word comes from Old French — "franchise", from "franc", meaning "free".

In a more contemporary business context, the terms "franchising" and "franchise" are often used interchangeably to mean a business, a type of business, or an industry. Strictly speaking, the "franchise" is the agreement or license between two parties which gives a person or group of people (the franchisee) the rights to market a product or service using the trademark of another business (the franchisor). The franchisee has the rights to market the product or service using the operating methods of the franchisor. The franchisee has the obligation to pay the franchisor certain fees and royalties in exchange for these rights. The franchisor has the obligation to provide these rights and generally support the franchisee. In this sense, franchising is not a business or an industry, but it is a method used by businesses for the marketing and distribution of their products or services.

<u>Franchisor:</u>	<u>Franchisee</u>:
Owns trademark	Licenses trademark
Provides support: training advertising marketing financing (sometimes)	Runs business with franchisor's support
Receives fees	Pays fees

There are many businesses, organizations, and even some government agencies that grant franchises. In sports, teams are referred to as a "franchise".

In telecommunications, government agencies grant licenses to radio, TV, and cable operators that are referred to as "franchises". This research study is focused on two other types of franchises – product distribution franchises and business format franchises.

PRODUCT DISTRIBUTION FRANCHISES

Product distribution franchises sell the franchisor's products and are supplier-dealer relationships. In general, the franchisor licenses the use of its trademark to the franchisee but may not in all cases provide the franchisee with a system for running its business. Examples of product distribution franchises are soft drink distributors (Pepsi) , automobile dealerships (Ford), and gas stations (ExxonMobil).

Business format franchises not only sell the franchisor's product or service, with the franchisor's trademark, but operate the business according to a system provided by the franchisor. The franchisor provides training, marketing materials, and an operations manual to the franchisee. There are many examples of business format franchises, including – quick service restaurants (McDonald's), automotive services (Meineke Car Care Centers), lodging (Marriott), real estate agents (RE/MAX), convenience stores (7-Eleven), and tax preparation services (H&R Block).

The typical franchise company (franchisor) will have establishments that are operated by franchisees as well as establishments that are operated by corporate employees. In addition, there are many types of franchise arrangements. The franchisor may offer a single-unit franchise, the license to own and operate one establishment for a set period of time, and/or the franchisor may offer multi-unit franchises, the license to own and operate many establishments over a set period of time.

Modern business format franchising really took off in the United States in the late 1950's and early 1960's. There were many causes for the rapid adoption and use of franchising by many entrepreneurs and by many businesses. In a study conducted by the Naisbitt Group for the International Franchise Association in 1989, John Naisbitt, author of *Megatrends,* wrote, "The boom in business format franchising is a result of ... the shift in the U.S. economy from production of goods to the providing of services. In particular, services that fill the needs of life-styles." Other trends that Naisbitt noted were working women and two-income earner families and the consumer desire for convenience and consistency. The rise of mass marketing and the increasing mobility of the American people, from cities to suburbs, and from urban concentrations in the Northeast to across the country fueled the growth of franchise businesses. Over the past 50 years, for many reasons, American consumers have come to rely on well-known brand-names for a wide range of products and services provided by franchise businesses located in every community, in every shopping mall, and along the highways.

There are other methods of business expansion, including wholly company-owned chains. As an economic model, however, franchising has been so widely embraced because it provides the franchisor:

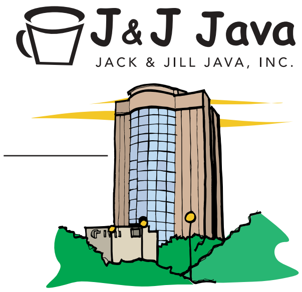
- a method of expansion using the franchisee's capital, which allows for a faster rate of system expansion as well as a source of capital;
- the motivation of franchisees that comes from owning their own business rather than being employees.

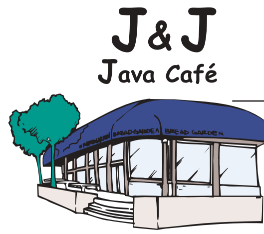
There are disadvantages for the franchisor as well, such as a lessened degree of control over franchised establishments .

For franchisees, franchising provides the advantages of affiliation with an established trademark and system of operation. The franchisor also provides initial and on-going training and support, the benefits of advertising programs, and in some cases the advantages of bulk purchasing programs. Both franchisor and franchisee have a strong vested interest in the success of the brand and keeping their customers happy.

It might be helpful in understanding how franchising works if we picture a stop in a typical franchised quick service restaurant and ask who actually does what —

(FRANCHISOR)





(FRANCHISEE)

Who does what?

	Franchisor:	**Franchisee:**
Site selection:	*Probably oversees, may choose*	*Chooses with approval*
Design:	*Provides prototype design*	*Implements design; pays*
Employees:	*Generalized recommendations*	*Actually hires, supervises and fires*
Menu:	*Set by franchisor*	*Changed only by approval*
Prices:	*Recommendations, possible caps*	*Decides actual prices*
Supplies:	*May offer bulk purchasing program or* *Lists approved suppliers or* *Lists quality requirements or* *Requires supplies from franchisor*	*Complies with program*
Advertising:	*Designs national program* *Requires or Suggests local amounts*	*Pays into advertising fund* *Gets franchisor approval*
Quality control:	*Sets standards; trains franchisees;* *Inspects*	*Trains employees, carries* *out systems*

Obviously, the franchised restaurant as you experience it involves both franchisor and franchisee. For more information about franchising, visit the IFA website at www.franchise.org.

A WORD ABOUT TERMINOLOGY

As noted above, this study focuses on two types of franchised businesses – business format franchises and product distribution franchises. Throughout this report, when we use the term "franchised businesses", we are describing in the broadest sense all those businesses that makeup the franchise system – the corporate or parent organization, the company-owned and operated units, and the franchisee-owned and operated units. In most franchise systems, the vast majority of establishments are owned and operated by franchisees with a relatively small percent of establishments owned and operated by the franchisor.

ABOUT FRANCHISING RESEARCH

While the adoption and use of franchising as a method of marketing and distributing products and services has become widespread both in the U.S. and abroad, there has been very little broad-scale economic research about this phenomenon. No government agencies currently collect comprehensive data on franchise businesses. The federal government's Standard Industrial Classification (SIC) and North American Industrial Classification System (NAICS), which are used to track labor statistics and which provide the basis for the U.S. Business Census, do not include separate identifiers for franchise businesses. The U.S. Department of Commerce, as noted below, ceased its publication of annual reports on franchising in 1988. While many government agencies and private institutions provide regular reports on many facets of the U.S. economy, there is no body of statistical reports about franchise businesses in the U.S.

There are two series of research reports that merit mention —

The *Franchising in the Economy* reports published by the U.S. Department of Commerce (USDOC) from 1972 to 1988 and by the IFA Educational Foundation in 1989, 1990, and 1991 were based on annual surveys of franchisors. These annual reports included information on both business format and product distribution franchising. The reports included information about the number of establishments, sales, and general trends. At the time of their publication, these annual reports were the only source of statistical information about franchise businesses in the U.S. and they were widely referenced.

In 1995, the IFA Educational Foundation undertook a three-year research project to gather data about franchisors and their operations. Because the previously mentioned *Franchising in the Economy* reports had relied entirely on surveys of franchisors, the Foundation determined to explore other sources of data. The result was the *Profile of Franchising* series, 1996-1997-1998. The *Profile* series was based on a collection and analysis of data from Uniform Franchise Offering Circulars (UFOCs) filed and registered in one of the 12 states that require franchisors to register their documents prior to the sale of a franchise. Each 300+ page volume of the *Profile* series, reported on a wide range of information about franchise systems, including – the number of domestic franchised units, the number of company-owned units, the size of franchise systems, the years in business, the type of corporate structure, initial franchise fees, and other factors.

While these reports provided very useful information about the size and scope of franchise business activity in the U.S., neither the *Franchising in the Economy* or the *Profile of Franchising* series attempted to measure economic impact. This is the focus of our study — to measure the economic impact of the franchisors, franchisees, employees and suppliers that collectively makeup the franchising sector of the U.S. economy.