3.2 OWN A FRANCHISE OR START A BUSINESS

JUMP START

After looking at existing businesses, Abbie and Kaito considered starting a new business. If they opened a new business, not only would they have to find a place to locate the bakery, but they would also have to buy everything needed to get started and build up a customer base. Another option they considered was buying a franchise for Mrs. Fields' Cookies. A franchise would offer help in finding a location and ordering supplies. But they wondered if they would be able to use some of their own recipes if they operated a franchise. What are some other questions to consider when starting a business or owning a franchise?

GOALS

Evaluate franchise ownership

Recognize the advantages and disadvantages of starting a new business

KEY TERMS

franchise, p. 67
franchise fee, p. 68
royalty fee, p. 68

Franchise Ownership

Purchasing a franchise is another route by which you can become an entrepreneur. Jiffy Lube stations are franchises. So are many McDonald's restaurants. Private entrepreneurs who operate them as their own businesses own these retail outlets.

A **franchise** is a legal agreement that gives an individual the right to market a company's products or services in a particular area. A *franchisee* is the person who purchases a franchise agreement. A *franchisor* is the person or company that offers a franchise for purchase.

More than 909,000 franchises are operating in the United States, and the number is growing. Franchising opportunities are available in virtually every field from motels to pet stores to video outlets. *The Franchise Opportunities Handbook*, a publication of the U.S. Department of Commerce, lists more than

1,400 franchise opportunities by category. It also provides information about costs and capital requirements. Sources for finding out about franchise opportunities include the following.

1. *Buying a Franchise: A Consumer Guide*, published by the Federal Trade Commission
2. Books on franchising available at your public library
3. *The Wall Street Journal*
4. Magazines such as *Forbes*, *Barron's*, *Entrepreneur*, and *Inc.*

Operating Costs of a Franchise

If you decide to purchase a franchise, you will have to pay an initial franchise fee, startup costs, royalty fees, and advertising fees. You may also be asked to pay for nationwide advertising of the franchise.

The initial **franchise fee** is the fee the franchise owner pays in return for the right to run the franchise. The fee can run anywhere from a few thousand to a few hundred thousand dollars. It is usually nonrefundable. *Startup costs* are the costs associated with beginning a business. They include the costs of renting a facility, equipping the outlet, and purchasing inventory. A **royalty fee** is a weekly or monthly payment made by the owner of the franchise to the seller of the franchise. Royalty payments are usually a percentage of your franchise's income. *Advertising fees* are paid to support television, magazine, or other advertising of the franchise as a whole.

Jim Saurbrey purchased a Mr. Rooter franchise, a company that provides plumbing services. In return for the right to use the Mr. Rooter name and logo, Jim paid a franchise fee of $17,500. In addition to this fee, Jim spent $30,000 renting office space, leasing vehicles, and purchasing equipment.

During its first year of operation, Jim's franchise earned $36,000 in profits. He returned 4 percent of those earnings, or $1,440, to Mr. Rooter in royalty fees. During Jim's second year in business, his company earned $51,000. That year he paid $2,040 in royalty fees.

Business Math Connection

Franchise operators often charge franchisees a percentage of sales as a royalty fee. If your sales totaled $5,600 in a month and the royalty is 10 percent a month, how much royalty fee would you pay?

SOLUTION

To calculate the royalty fee, multiply the sales by the royalty rate.

Sales	×	Royalty rate	=	Royalty fee
$5,600	×	0.10	=	$560

The royalty fee would be $560.

Advantages of Owning a Franchise

There are four main advantages to owning a franchise.

1. **An entrepreneur is provided with an established product or service.** This allows entrepreneurs to compete with giant companies.
2. **Franchisors offer management, technical, and other assistance.** This assistance can be onsite training or classes, aid with starting the new business and handling daily operations, and tips on crisis management. Some franchisors even offer help on everything from site selection and building design to equipment purchases and recipes. Most franchisors also maintain toll-free telephone numbers that franchisees can call for advice.


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What kind of assistance might franchisors offer?

Cross-Cultural Relationships

INTERNATIONAL FRANCHISES

Many entrepreneurs are finding franchising opportunities overseas. The key to success is finding the right fit. A country's customs and traditions must be taken into account. In the past, the lifestyles of foreigners were not always compatible with many U.S. business practices. But now, changing lifestyles have created unfulfilled needs that U.S. businesses can meet. For example, Home Instead Senior Care, which offers home care for senior citizens, has over 140 franchise locations in Japan. This is largely due to changing traditions that once dictated that aging parents be cared for by the women in the family. Now, many Japanese women have jobs outside the home, so families are looking for professional caregivers. Curves, a women-only fitness center, is also benefiting from Japan's changing lifestyles with over 740 franchise locations there.

Think Critically

Why are international franchises becoming a popular way of doing business? What should an entrepreneur consider before expanding abroad?

3. **Equipment and supplies can be less expensive.** Because franchises are parts of large chains, they are able to purchase in huge quantities. Some of the savings they enjoy as bulk purchasers are passed on to the franchisee.
4. **A guarantee of consistency attracts customers.** Because a franchise contract mandates a certain level of quality, consumers know that they can walk into a franchise anywhere in the country and receive the same product or service. The cheeseburger sold at a Wendy's in Long Beach, California, will be very similar to the cheeseburger sold in Towson, Maryland. The quality of a room at a Ramada Inn in New Jersey will be much like the quality of a room at a Ramada Inn in Oregon.

Disadvantages of Owning a Franchise

Although franchising sounds like a great idea, there are four main disadvantages you need to consider.

1. **Franchises can be expensive and cut down on profits.** The initial capital needed to purchase a franchise business often is high. Also, some of the profits you own as a franchise owner are returned to the franchisor as royalty fees.
2. **Owners of franchises have less freedom to make decisions than other entrepreneurs.** Many of the business decisions that entrepreneurs generally make themselves have already been made for franchisees. Franchisees must offer only certain products or services, and they must charge prices set by the franchisor. Many entrepreneurs object to this type of control because it inhibits the freedom they sought as independent business owners.
3. **Franchisees are dependent on the performance of other franchises in the chain.** A franchisee can benefit from the successes of other franchisees. But if other franchisees run sloppy operations, customer opinions of the chain will decline. As a result, customers may stop going to a franchise, even if a particular store maintains high standards.
4. **The franchisor can terminate the franchise agreement.** If the franchisee fails to pay royalty payments or to meet other conditions, the investment in the franchise can be lost. Similarly, when the franchise expires, the franchisor can choose not to renew the agreement.

How can franchises be affected by other franchises in the chain?

LOW-COST FRANCHISES				
Franchise	**Description**	**Franchise Fee**	**Startup Costs**	**Royalty Fee**
Instant Tax Service	Retail tax preparation	$39,000	$39,000–$89,000	20%
Jani-King	Commercial cleaning service	$8,600–$16,300	$11,300–$34,100	10%
Quiznos Subs	Submarine sandwiches, soups, and salads	$25,000	$24,100–$341,800	7%
Kumon Math and Reading Centers	Supplemental education	$1,000	$30,960–$129,400	$30+/student/month
Coffee News	Weekly newspaper distributed at restaurants	$6,000	$9,400	$20–$75/week

Evaluate a Franchise

There are many things to consider when purchasing a franchise. These are questions you should ask to evaluate a particular franchise.

1. What is the projected demand for the franchised product or service in the area in which I want to locate? Will I be guaranteed an exclusive territory for the duration of the franchise term, or can the franchisor sell additional franchises in the territory?
2. What are the costs and royalty fees associated with the franchise?
3. How profitable have other franchises in the area been? What do other franchisees think of the franchisor?
4. How long has the franchisor been in business? How profitable is the franchisor?
5. What services does the franchisor provide? Will the franchisor help me with marketing, merchandising, and site selection?
6. Are the benefits provided by the franchisor worth the loss of independence and the cost of purchasing the franchise?
7. What happens if I want to cancel the franchise agreement?

Some franchisors make false or misleading claims about their franchises. To make sure that you are not being cheated or misinformed, carefully study the documents the franchisor gives you. Be suspicious of any company that will not back up its claims with written financial statements. Also beware of high-pressure sales tactics. A franchisor that tries to get you to sign a franchise agreement right away is probably not offering you a good business opportunity. It is also a good idea to talk to other franchisees to learn about their experiences with the franchise. Do not commit to a franchise until you are completely sure of your decision. Never allow yourself to be pressured into making the decision too quickly.

Franchise agreements are complicated legal documents. Because they can be difficult to understand, you should never sign one without consulting an attorney. Let your attorney know what promises were made to you orally. Then ask your attorney to confirm that the same promises appear in the contract.

CheckPOINT

What are some of the questions you should ask when evaluating a franchise opportunity?

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Start Your Own Business

For one reason or another, running an existing business, joining a family business, or operating a franchise may not be possible for you, or it might not be right for you. This means that to be an entrepreneur, you will have to establish a business of your own. You need to consider the many advantages and disadvantages of starting your own business.

What kind of decisions do entrepreneurs have to make when starting their own business?

Advantages of Starting Your Own Business

Entrepreneurs who start their own business get to make decisions about everything from where to locate the business to how many employees to hire to what prices to charge. They are completely independent and decide their own destinies. Many entrepreneurs find enormous satisfaction in starting their own business. Many are attracted to the challenge of creating something entirely new. They also get a great feeling of triumph when their business turns a profit.

David Srivastava started his mail-order business, In a Jam, from his home. David started by selling dried fruit through the mail. After a year and a half of disappointing sales, David began offering preserves and jams, products he felt had greater sales potential. He also put more effort into packaging, and he designed the labels for the jars himself. His instincts proved correct: eight years after starting out alone in his basement, David now has accounts with several large retail stores, and his company has 14 full-time employees.

TEAMWORK

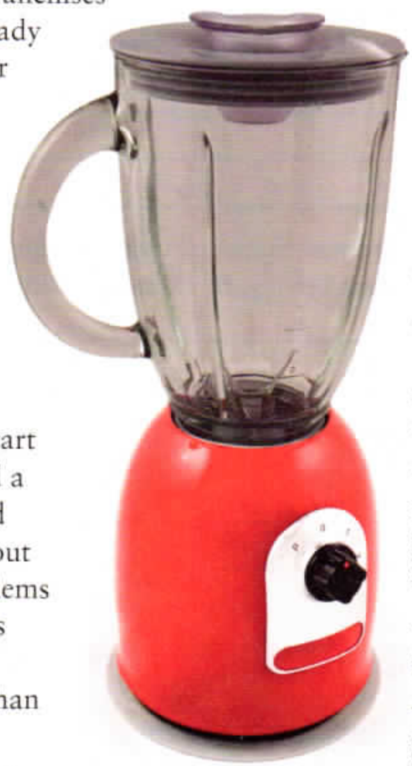
In small groups, debate the pros and cons of starting a business from scratch for each of the following areas: restaurant, retail gift shop, and home improvement.

Disadvantages of Starting Your Own Business

There are also many risks to consider when you start your own business. You must estimate demand for your product or service. There is no certainty that customers will purchase what you offer. Entrepreneurs who join family businesses, buy an existing business, or buy franchises do not have this uncertainty because it is already known that customers will buy the product or service.

Entrepreneurs who start their own business also must make decisions that other types of entrepreneurs need not make. What product or service to offer, the location, what employees to hire, and many other decisions must be made. The results of what may seem to be good decisions may not always be positive.

Lucy Chang realized how difficult it is to start a new business from scratch when she opened a kitchen accessories store. Lucy had considered purchasing a store franchise but had ruled it out because of the high franchise fee. Lucy's problems began when she discovered that her customers thought her location was inconvenient. As a result, fewer customers shopped in the store than Lucy had projected. Contacting suppliers was more difficult than Lucy anticipated, and many of them proved to be unreliable. The high-priced items Lucy purchased in the hope of increasing profits did not sell well.



What risks does a new business owner face when making product decisions?

CheckPOINT

Why do many entrepreneurs prefer to start new businesses rather than purchase existing businesses or franchises?