Deal with risks between different franchise agreements[1, 2]

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Abstract

Europe is the most dynamic sector around the world for franchises business, 14 000 franchisors are registered. Moreover, this number is raising up year after year since 1930. According to this information we can think that the franchise unit is an easy way to set up. But what's happened in reality? What are the main risks when someone decide to sign his first franchise agreement? How could we be sure to sign the more relevant franchise agreement? Thanks to this paper the reader will be able to understand the difference between the direct franchising and the master franchising agreement. Then a comparison between four agreements will be developed. By using the additive weighting technique, we are going to prove that multi-unit agreement with an area development is the best choice for handling a successful business without any particular background.

Keys words: Franchise qualities, Contractors, Security, Franchisor, Franchises, Viability, Business success

Introduction

Nowadays, the franchise sector in France represents more than 55 billion of euros every year. The number of franchisors has tripled between 2004 and 2016. In France, this dynamic sector includes 1900 franchisors for more than 70 000 franchises. These numbers are not impressed when you know that franchisor has twice as likely to overpass two years of its existence instead of an individual company.

Under the definition of Oxford dictionary, a franchise is defined as: « An authorization granted by a government or company to an individual or group enabling them to carry out specified commercial activities, for example acting as an agent for a company's products. »

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Franchise contract is signed between two independent parties. The franchisee will have the right to use services under the operating methods of the franchisor. Besides, the franchisor will provide rights and resources to support the franchisee.

The most notorious names in this sector are:

- 7Eleven: food and various product distribution stores, born in 1920 in the US, which includes 60 000 stores in 18 countries
- Subway: fast food restaurants, born in 1965 in the US, which includes 44 500 restaurants 27 000 of which are in US
- MacDonald's: fast food restaurants, born in 1955 in the US, which includes 36 000 restaurants around the world

Many rumors say that buying a franchise is an easy way to set up: « Everything is all set-up for you », « You're buying a business in a box when you buy a franchise ».
Within all of these sentences, how could we find an objective point of view to look for the most successful business? Which are the exact risks when we decide to set up a franchise unit?

This document aims at, first defining the main risks within a franchise contract and then to identify and analyze them against different franchise agreements.
Thanks to this essay, the future contractor will be able to understand the different handling risks between different contracts. This essay will go further through the pros of franchise ownership and the cons of franchise ownership. Then, we will able to know which agreement is going to be the most relevant for handling a successful franchise business without any particular background.

Methodology

Development of feasible alternatives

Franchise is a contract signed between two independent parties, which enhance two opportunities: for the owner of the brand, the franchisor, that will provide to him the opportunity to develop his brand into another area and collect benefit without his physical presence. On another hand, the franchisee will have the opportunity to receive all resources needed for managing his business under franchisor's standards. The aim of a franchise agreement is to detail all rights and obligations of both parties within a period of time.
The franchisors have different sources of revenues as fees, costs or penalties against the terms of the contract (for example: - as initial fees: breach of agreement fees, site, equipment, initial inventory… - occurrence fees: audit costs, loss of manuals, liquidated damages, successor, renewal agreement fees…) Besides, the franchisor will also receive royalties generally based on the franchisee's gross sales. Theses royalties can be fixed or variables against the terms of the contract.

Before the contract's signature, the two parties should analyze and choose between the possibilities of the different agreements. There are two types of franchises agreements:

- **Direct franchising**
  - Single-unit
  - Multi-unit with an area development
  - Area representation
- **Master franchising or subfranchising**

Development of the outcome and cash flow for each alternative

For understanding the best choice to handle a successful franchise business, we will develop the exact characteristics of each feasible alternative:

Direct franchising:

- **Single-unit**

The direct franchising is characterized by two independent parties.
It provides to the franchisee the right to open and operate one establishment (called unit). Generally, the signatory of the agreement will be the manager of the unit, but this term may differ under the condition of the contract.
Mostly, the franchisees of a single unit have a personal loan for covering their initial investments so their motivation is engaged for operating a successful business then related to the gross sales of the unit the franchisee will provide royalty to the franchisor.

- **Multi-unit with an area development**

The single unit and the multi-unit agreements works under the same principles. For the multi-unit case, the franchisee operates his units through different managers but each unit will be separate under one franchise agreement. Generally, the initial fees are divided between a first payment and ongoing fees for each unit opened. Besides, the franchisor will receive royalty payment related to the gross sales of the different opened units.

Acquiring a multi-unit agreement requires a higher initial capital than a single unit but growing a franchise via single unit franchising takes time. By the end of the development of single-unit agreement is going to be more expensive than multi-unit franchising. The area development agreement allows the franchisee to open units within one specific location. The franchisee earns the right to open units within the localization term and an agreed time term. In general, area development contracts are signed for 5 years.

- **Area representation**

Franchisor allows an authorized representative the rights to seek some potential franchises and provide services for existing franchises. The authorized representative doesn't establish contracts with franchisees.

All different direct franchising agreement may be combined into one contract. Concretely, a franchisor should allow the right for a multi-unit with an area development, and also work as an authorized representative with an area representation agreement.

Master franchising:

The master franchising is characterized by a tripartite relation: franchisee, franchisor and master franchisee. The owner of the master franchise agreement signs his franchisee agreement with the franchisor within an agreed period of time, generally it is a long time agreement with a specific geographical localization. This contract will provide to him the right to open a unit and the right to sub-franchisee others independents units. Franchisor tend to look more for master franchising because generally the taker is better capitalized and more sophisticated in business than the franchisee of one or multi-unit. For the most part, they are represented by legal counsel which have better understanding of theirs rights and obligation under their franchise agreement. Moreover, because of their backgrounds, they able to operate their businesses more easily and are more willing to handle risks related to their businesses and market changes.

The master franchisee will operate all financial responsibilities and all managerial responsibilities for all different units. This type of agreement is often signed to proceed as an international development. The contract will included a development schedule with the minimum of the number of franchise units that should be opened into the specific area. If the condition is not realized, the agreement should contain term for providing solution: « limiting the scope of the exclusively granted for termination of agreement ».

The master franchise agreement will include two types of revenues for the franchisor. The first one, is the initial fee for the rights granted, and the second one is royalty, calculated within the revenue of the master franchise (this ongoing fee may be fixed or variable against the terms of the contract).

Selection of a criteria

To identify which alternative is more likely to be successful, we will analyze the four possibilities of agreements against some selected criteria:

1- Training/Following/Support: If the franchisor provides a helpful resource for the franchisee?
2- Duration effectiveness: How long is the process to be setup? is it durable solution?
3- Safety: Does the franchisee handle a safety process against the sign of the contract?
4- Cost: What is the amount related to initial payment and royalties?
5- Legal constraints: Does the contract provide many mandatories terms under the contract?
6- Opportunities development: Does the agreement provide development possibilities?

Findings

Analysis and comparison of the alternatives

Matrix Analysis matrix				
Alternatives	Direct franchising			Master franchising
Attributes	Single-unit	Multi-unit with an area development	Area representation	
Training/Following/Support	1	1	0,5	0,5
Duration effectiveness	0,5	1	1	1
Safety	1	0,5	0	0
Cost	1	1	1	0
Legal constraints	1	1	1	0
Opportunities development	0	0,5	0	1
SUM	4,5	5	3,5	2,5

Thanks to this matrix analysis, direct franchising: multi-unit with an area development term seems to be the more relevant way for handling a successful business with any particular background.

			Direct franchising						Master franchising	
Attributes			Single-unit		Multi-unit with an area development		Area representation		Master franchising	
Training/Following/Support	5	0,24	1	0,24	1	0,24	0,5	0,12	0,5	0,12
Duration effectiveness	1	0,05	0,5	0,025	1	0,05	1	0,05	1	0,05
Safety	4	0,19	1	0,19	0,5	0,095	0	0	0	0
Cost	2	0,09	1	0,09	1	0,09	1	0,09	0	0
Legal constraints	3	0,14	1	0,14	1	0,14	1	0,14	0	0
Opportunities development	6	0,29	0	0	0,5	0,145	0	0	1	0,29
SUM	21	1,00	SUM	0,685	SUM	0,76	SUM	0,4	SUM	0,46

Selection of the preferred alternative

By using the additive weighting technique, we are able to produce a ratio scale to prove the best option among all of alternatives. 0,685/0,4 = 1,7125*100 = 171,25%.
For doing this calculation, we rank the attributes from the most important: opportunities development (which got 6 points) to the less one: duration effectiveness (which got 1 point).

- Opportunities development: 6 points
- Training/Following/Support: 5 points
- Safety: 4 points
- Legal constraints: 3 points
- Cost: 2 points
- Duration effectiveness: 1 point

According to our calculations, we can conclude that multi-unit with an area development is a better choice by 171,25%.

Opportunities development: This agreement will provide to its owner a strong development opportunity. If the business is successful, the owner will raise its income and gain the possibility for investing in other units. Except for a specified term, the signatory will be able to extend its units with no maximal limitation number within a defined geographic localization.

Training/Following/Support: The terms of the contract oblige the franchisor to give to his franchisee a training for its operational tasks. He will receive a physical help, a book training or online e-learning for working within the standards of the brand. Depending of the agreement the franchisee will pay or will receive the mandatory material for selling the products or services

(I.e.: furniture, an access to the technology of the franchisor: payroll software). Then an ongoing support will be provided by a call center or a franchisor representative.

Safety: The agreement has no option to be terminated before the expire of the term except if the signatory handles breaches related to an essential term ("condition") of the contract, do a seriously breaches of a "warranty" or act against the standards of the contract ("repudiation").

Legal constraints: The signatory will sign to develop an agreed number of units within a geographical but all the units will be signed under the same agreement and the owner will act as general manager, so he is able to control all processes within its stores.

Cost: The agreement's fees are explicitly defined in the agreement. The signatory will provide only one initial fee for the rights granted of every unit, then based of the gross sales of the different units, variable or fixed royalty will be provided to the franchisor.

Duration effectiveness: 5, 10 or 20 years are the typical length of most franchise agreements, then the franchisee has a possibility to renewal.

Different issues handling by the others agreements:

- The single-unit won't provide an extending opportunity, except if the franchisee wants to pay for another single-unit agreement for opening a new unit but this option is going to be more expensive than the initial fee of multi-unit agreement.

- The master franchisee is engaged against financial & managerial responsibilities for every opened unit, he will act as a franchisor against every opened unit. Related to his position, he will face many legal constraints against the signature of the different opened units for avoiding breaches of contracts' term, breaches of a warranty or a repudiated act include into the initial master franchise agreement. For the majority, the master franchisee legal part is handled by an official law representative.

- The initial fee of the master franchise is very costly related to the expending opportunity; an exact price is hard to define depending of the activity sector. It may cost more than €1,5million then the signatory has to add the amount for the main unit based and the cost of the launch network.

- The agreement of area representation doesn't give the opportunity to own a properly unit, the signatory will work as a salesperson for the franchisor. He has no link with the operational processes within the units. Thanks to his consultant position he will perceive a percent of the initial franchise fee of each newly signed agreement.

Follow-on Research

Performance Monitoring and post-evaluation of results

Handling a successful franchise business is based on two main principles. The first one is to be knowledgeable; the signatory needs to have some strong technical competences in the activity sector. The second one is to establish a confidence relationship with the franchisor to be sure that you are going to sign the most acceptable agreement against your needs.

The signatory needs to understand all contract terms and analyze what are the future ongoing of all conditions, warranties which will refer to the agreement.

For doing this part, the best way is to use franchise network. Find general managers who have already opened unit and work in the same targeting sector. A successful franchise owner will know how to work independently and how to find an answer to his business questions against his franchise network.

Conclusion

The aim of this paper is to understand the handling risks against the different franchise agreements: direct franchising agreement (single-unit, multi-unit with an area development, area representation) and master franchising agreement. Thanks to the analyze against 6 relevant criteria: opportunities development, training/following/support, safety, legal constraints, cost and duration effectiveness; we can give the proof that the multi-units' agreement with an area development is going to be the most relevant agreement for handling a successful franchise business without any particular background.

As a follow up to this paper, a comparison between the different franchise agreements against few concrete life cases will be a good opportunity to understand the importance of the signatory background against the choice of the franchise agreement.

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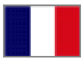

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