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Sales Tactics

Why sell sizzle when you can sell the steak? Here's how it's done

By Dennis L. Monroe

There is a great deal written on how to attract franchisees to a franchise system. When Googling the topic, one gets such article titles as "marketing to attract franchisees," "eight seldom asked questions before you buy a franchise," and "secret weapons for attracting franchisees." In most cases, the articles focus on polishing the apple and telling an effective story about the franchise concept.

These types of articles only provide part of the advice. Let me attempt to provide a different take. My approach revolves around a detailed understanding of the financial aspects of the franchise unit and the return and risk of the investment in the units by potential franchisees or existing franchisees.

Solid financials a must

Franchisors seem to always be looking for sophisticated franchisees, such as multi-unit operators, private equity groups, groups with available financing, or just strong operators. A franchisor should know that selling existing franchisees on the financial benefits of their system is key and a way to generate development. These efforts require good, supportable financial information. Here are the top things I propose for this all-important effort:

Use an effective earnings claim. Too often financial performance representation (Item 19 of the Franchise Disclosure Document) is only based on sales information. This is nothing more than the cover of the book.

One reason for just providing simple information is the issue of gathering information from franchisees. To assist, make sure the franchise agreement states the franchisee supply detailed unit and company financial information certified by an officer for accuracy.

The next problem is getting the information in on time for the annual renewal of the FDD. We suggest doing supplemental filings or including information in the FDD from the previous year.

Include an appropriate pro forma balance sheet. Franchisors should have a detailed understanding of what an appropriate pro forma balance sheet should look like for franchisees to be able to grow and get the type of return on investment they want. Most franchisors approach balance sheets strictly from their side, but it needs to be looked at from the franchisee's side as well.

What type of leverage can a franchisee get? What type of equity does the franchisee need to invest? How can the franchisee potentially use sub debt? How will the new accounting rules regarding capitalization of every kind of lease relate to effective leverage?

The franchisor needs to consider these questions and develop appropriate balance sheets. Every franchisor would love to see debt-free franchisees but this is not realistic; therefore, reasonable debt-to-equity ratios are a must.

Emphasize return on investment. Return on investment is a key component to any franchisee's business model. The franchisor needs to understand the return on investment matrix for a normal performing unit.

The return should be computed assuming a reasonable degree of leverage and equity. The franchisor should develop a sensitivity analysis based on varying degrees of leverage. The return is not only based on cash but also on the overall investment (including capitalization of leases). A high return (20 to 40 percent) on total investment is a strong incentive.

Include the return on remodel projects. It is amazing how many franchisors roll out remodel and upgrade projects without a clear understanding of the franchisee's return on investment and without enough data to show the potential financial benefits. Unfortunately, some franchisors have been involved in lawsuits over this very issue.

Be realistic about unit performance. The more understanding the potential franchisee has of the risk profile of a unit, the more the franchisor will attract the right type of franchisee to its system.

Prospective franchisees need to know the upside and the downside, assuming a unit is run according to plan. This understanding can be gained through a broad sampling of system units. We sometimes look at the mean "average" or the upside but we also need to look at the downside so the potential franchisee can more fully comprehend the risk profile.

Show how development will be financed. It is important to approach new-store development based on the ability of

the franchisee to secure needed capital in a timely manner. Too often development agreements are reached without full knowledge of how the resources can be secured and applied, and therefore there is an over-promise and under-deliver. New units are seldom developed just through cash flow. A realistic pro forma analysis that provides for appropriate capital, a realistic level of debt and timing for the needed dollars is critical.

Get active in financing. Readers of this column know I have long been a proponent of the franchisor's involvement in franchise finance. Tools a franchisor can use to secure financing are remarketing agreements, reasonable lease riders and substitution of operating partner agreements. This active approach to franchisee financing is a tremendous sales tool in today's tight credit market.

Do your benchmarking. Franchisors should do their best to compare their unit economics to competitive or similar concepts. Help the prospective franchisee identify why your system is superior in terms of profitability, return on investment and risk factor.

Show demographic and geographic data. A franchisor should provide prospective franchisees a detailed understanding of its customer profile, based on data, not conjecture. Further, the franchisor needs to have supportable data as to viable sites, based on the demographics of existing stores.

Tailor the franchise program. Franchisors need to tailor their franchise programs (such as royalties, personal guarantees or development rights) to the type of franchisee the franchisor is trying to attract. For instance, if the franchisor is trying to attract private equity or a large, multi-unit operator to its system, the franchisor has to be realistic concerning personal guarantee, assignability and non-compete issues.

Some franchisors have allowed sophisticated investor type franchisees to post letters of credit versus guarantees; other franchisors have just done away with guarantees. In the long run, personal guarantees are not terribly effective, are seldom pursued and are even more seldom effectively enforced.

Franchisors need to understand their audience and that one approach does not fit all. As long as there is adequate disclosure, the franchisor can certainly cater to the prospective franchisee.

In the end, the franchisor needs to provide a compelling financial analysis to attract and retain their targeted franchisees. Why sell sizzle when you can sell the steak? FT

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