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When or if to franchise

It's tempting to have someone else finance your expansion, but here's some food for thought

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BUSINESS PEOPLE WHO DEVELOP a successful concept often want to grow it, and in many cases they decide franchising is their growth vehicle. I have a client with a great concept that involves cinnamon rolls and deli sandwiches. It has become a cult favorite around a major university, and my client is often asked by visitors, "Are you selling franchises? I wish I could buy one." In securities law, that's what we call a "red herring." That means it is a trial balloon and people are often just intrigued by the idea of trying to own something they think is really cool. There's much more to franchising than that.

But let's say you're considering franchising your restaurant concept. What does it take to franchise, and when should you? First and most importantly, the stores that are open—ideally it's a number of stores—have to demonstrate strong unit economics. That means sales ought to be three times the investment. So if your investment is $300,000, your sales should be $900,000. That's just a guideline. Additionally, the profit at the store level should be somewhere between 15 to 20 percent, so that means on $900,000, you should make a profit anywhere between $135,000 to $180,000. That's really a key requirement, because if you're going to charge a royalty to the person buying the franchise, they need to make money after paying the royalty, which usually runs 4 to 5 percent of sales plus 2 percent for advertising paid to the franchisor. The unit economics have to support franchise costs and be reasonably attainable.

Second: "How many stores do I have to have to franchise?" I believe the more stores you have open, the better; but it's not necessarily quantity as much as quality. Owners who have one store open often claim they are ready to franchise because the unit economics work. But they may work well in that particular location but not in others. So a greater number of locations—say about 10 locations open with diverse geography and diverse or broad demographics—are needed to prove who your customers are and that there's demand.

The third condition is that the concept needs to be duplicated with available staffing to run it. You shouldn't expect your franchisee to be a chef or a whiz in finance, just a good business person.

In addition to choosing a good businessperson, the franchisor must provide the franchisee appropriate operating manuals, procedural guidelines, initial marketing plans, and in general, an overall template for implementing and hopefully evolving the franchisor's concept. The key is to have successful franchisees, therefore, the first few franchisees are the real key.

I can remember an Asian concept that had developed three highly profitable corporate stores, then tried to franchise. They sold to a select number of business people with little restaurant experience. In addition, they really had not developed any of the necessary manuals or training to assist the franchisees. All had problems and all wanted their money back. Which in most cases they received. There are no short cuts to good systems.

Fourth, if you're going to franchise, you have to realize it is a separate business. Franchising is not the same as running restaurants. Franchising is providing support to others who run a restaurant and making them successful. And to do so, you need to develop the infrastructure. The two most important parts of the infrastructure are operational support and site selection. The former involves training the staff and continually updating the menu and the food products, as well as the site. The latter demands a good understanding of the whole development function to assist in the site selection and getting the restaurant opened. Obviously, there are other kinds of support functions, like marketing support and franchise sales, but start with operations.

The fifth condition is putting together the appropriate documents for franchising. The document that's used for franchises in Minnesota is an FDD—Franchise Disclosure Document—with all the supporting agreements. Not all states have franchise regulations, but a number of states, like Minnesota, do. So both state and federal requirements must be complied with. Therefore, you need to have a good lawyer—a lawyer who understands restaurants but also understands creativity, realizing that restaurants take a while to become profitable. And your lawyer should also understand franchising.

The legal structure is important. In most cases, the franchisor is a separate entity, which contains its intellectual property, the trade name, all protected. Additionally, your lawyer is probably going to form a separate entity from your corporate stores and then license the intellectual property to the corporate store entity. Under franchise law, the franchise entity needs to be audited and it needs to be appropriately capitalized. To that end, your franchise entity (franchisor) must have adequate funding/equity, so the regulators and your potential franchisees understand you have sufficient resources to provide the necessary services to franchisees. If the franchisor is underfunded, they won't have enough money to hire the operational and development people as well as provide appropriate marketing support.

These are guidelines to becoming a restaurant franchise in Minnesota. As you are thinking about it, keep in mind there is still a great opportunity, and there are many successful restaurant franchises that have come out of this state. Yours may be the next one. But before you listen to that star-struck customer who thinks your concept will be perfect for Boise, Idaho, or a consultant telling you that you have the next McDonald's, go through the checklist discussed above—and then proceed slowly. Remember, even McDonald's wasn't built in a day. FSN

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