Trends: Emerging Franchisors

An Examination of New Franchise Concepts

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2018 Franchise Small Business Report

An Examination of New Franchise Concepts

Source Material

All information in this report was compiled from FDDs received and registered by state franchise examiners, and survey responses. Franchisors are required under state and federal laws to produce and deliver FDDs to prospective franchisees. As part of this disclosure process, certain state regulatory agencies require complete and updated FDDs to be filed and approved before a franchisor is permitted to sell franchising rights within their jurisdictions. These documents must be accurate by law.

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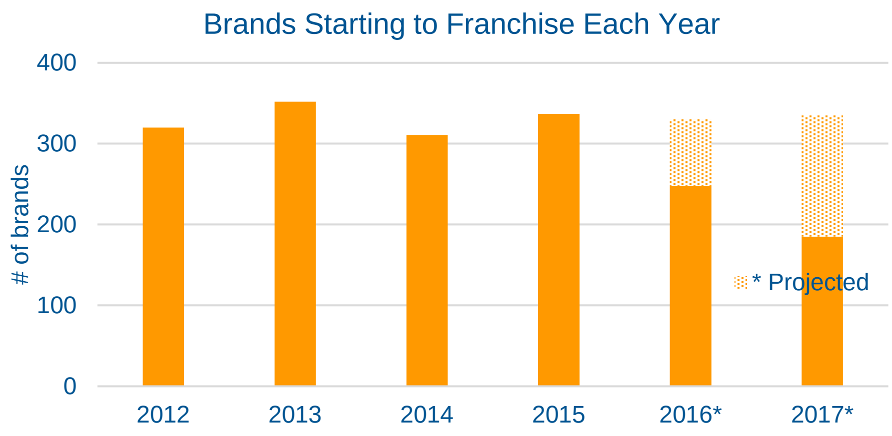
Franchise Business Intelligence

INTRODUCTION

The complex and dynamic franchise business model has always been a powerful growth strategy. In recent years, the market for franchised businesses in the United States has seen an influx of exposure, growth, successes, and challenges. New franchise brands appear every day, with an average of 300 brands beginning to offer franchise investment opportunities every year.

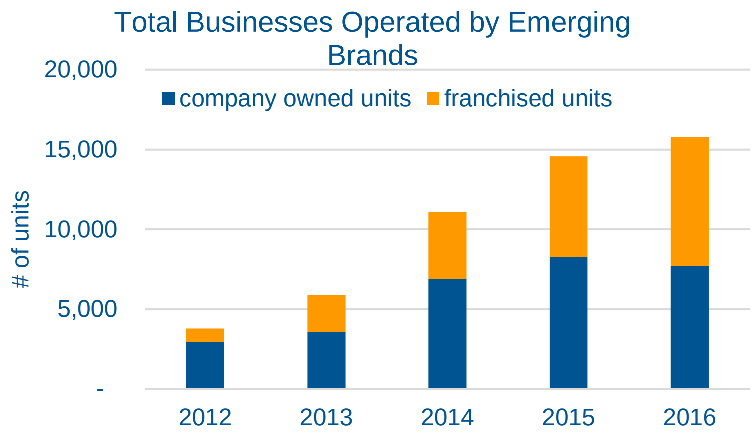
This study examines the trends, experiences and challenges of the 1,740 emerging brands that have started franchising since 2012.

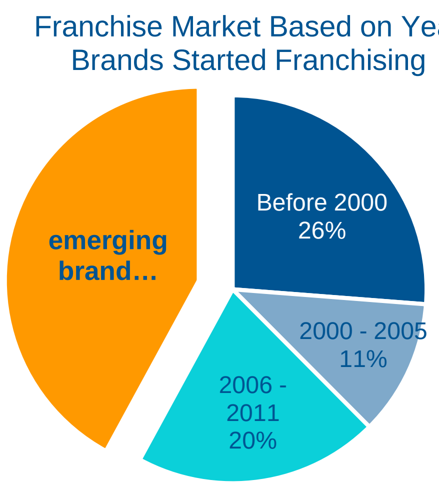


Over 40% of brands that currently offer franchises in the United States started franchising over the last five years.

While these franchise systems start small, the number of individual business locations in these brands is already a significant number: in 2016, emerging franchise brands contributed an aggregate total of over 15,000 franchised and company owned businesses to local economies across the country. Over the last 5 years, these emerging brands have added new units by 75% compounded annually, from 800 locations in 2012 to over 8,000 in 2016.

Emerging franchisors create new business opportunities to thousands of new and existing entrepreneurs and small business owners. In turn, these franchisors and the entrepreneurs operating their local franchised businesses create jobs, train their labor force, and provide goods and services to their local communities.





METHODOLOGY

The Franchise Education and Research Foundation of the International Franchise Association (IFA) partnered with FRANdata to assess the characteristics, experiences and challenges of new and emerging franchisors. A combination of in-house data analysis, survey analysis, and qualitative phone interviews lead to the discovery of the major findings of this study.

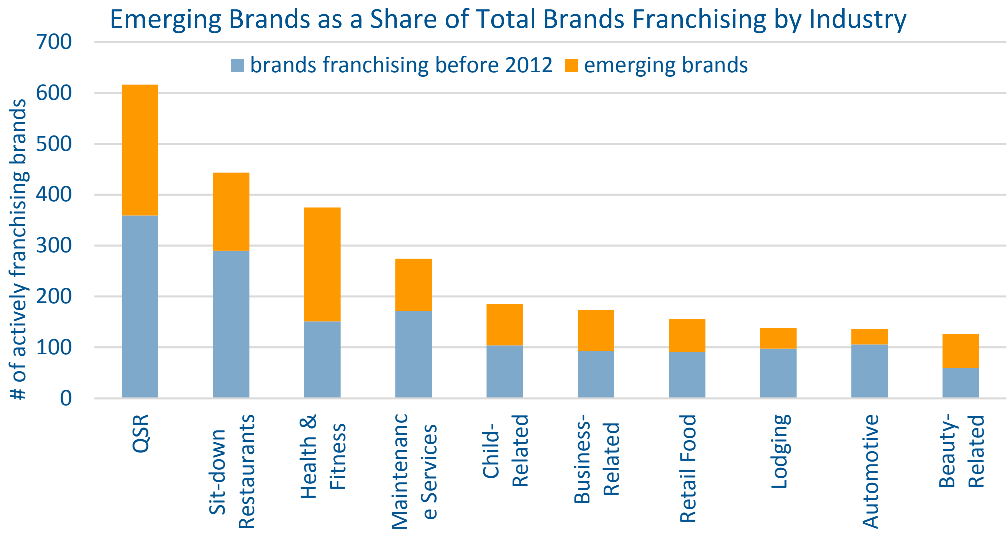
FRANdata identified 1,740 brands that have started franchising since 2012 through an in-house franchise database. This study assesses the first few years of a new franchise organization building their infrastructure and setting up for early franchise system growth. FRANdata analyzed in-house data to establish a basis for the quantitative findings, including unit patterns and growth in the first few years franchising (for both franchised and corporate owned units), unit openings, and details about the corporate structure of emerging franchisors.

FRANdata and the IFA conducted a short online survey of new franchisors to drive and support the major findings. The survey analysis is based on the responses of 75 emerging franchisors that are representative of the overall franchise space based on industry distribution and year started franchising. Following up on the online survey, FRANdata conducted almost a dozen phone interviews with emerging franchisors, digging deeper into their "start-up stories" to understand their experiences, motivations, and challenges.

The following major findings are supported by statistics derived from in-house data and the online survey, as well as anecdotal stories and quotes from phone surveys.

WHO ARE EMERGING FRANCHISORS?

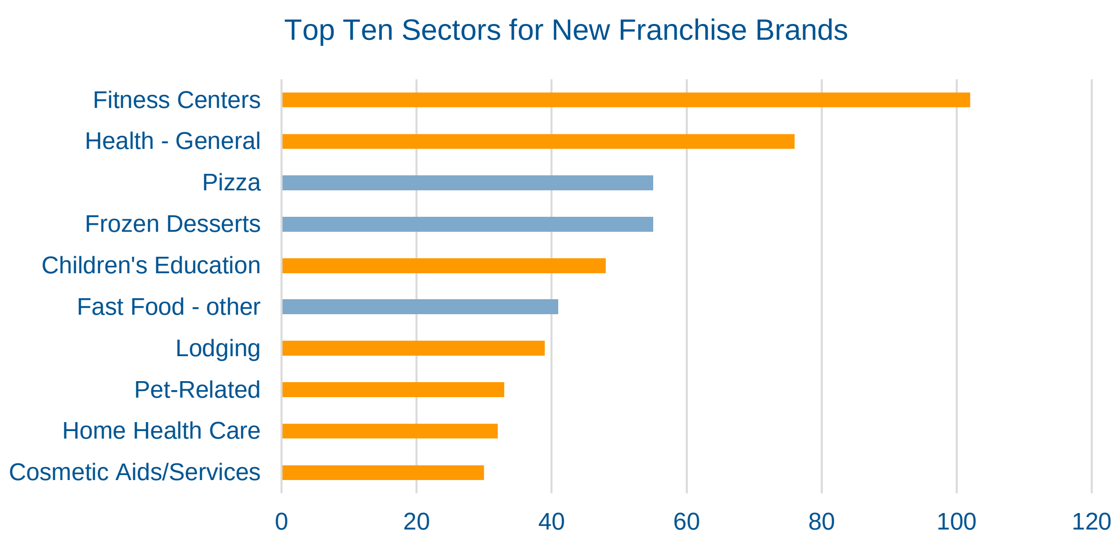
Franchising is gaining popularity and momentum as a viable method for expansion for business in all sorts of industries from food, lodging, retail, personal services, health care, business services, automotive and many others: 29 major industries and 188 sectors. In recent years, there has been a larger surge in nonfood and service brands, representing 65% of all new entrants.



Ten industries have more than doubled the number of brands franchising over the last five years. The health and fitness industry has seen the biggest gains, with 60% of all brands currently franchising in the space entered the market over the past five years. More specifically, the fitness sector has seen consistent growth in new brands entering the market. There has been a large shift in fitness concepts from big box gyms to increasingly more specialized fitness centers that feature classes and services, as opposed to just equipment.

Markets are getting crowded with the influx of new franchise brands across all industries, and emerging franchisors are creating niche spaces within the existing crowds, often creating new subsectors. This subsector specialization allows new brands to operate in spaces with less competition, offering specialized products and services, often targeting a specific consumer market.

The children's education sector has seen a similar shift in recent concepts entering the market. Since 2012, the number of franchise brands in the children's education space has doubled. These new concepts offer more specialized curriculums and programs for afterschool, extracurricular learning, summer camps, and events. There has been an increase in stem (science, technology, engineering, math) specific programs offering age appropriate curriculum for children of all ages, often starting as young as four years old.

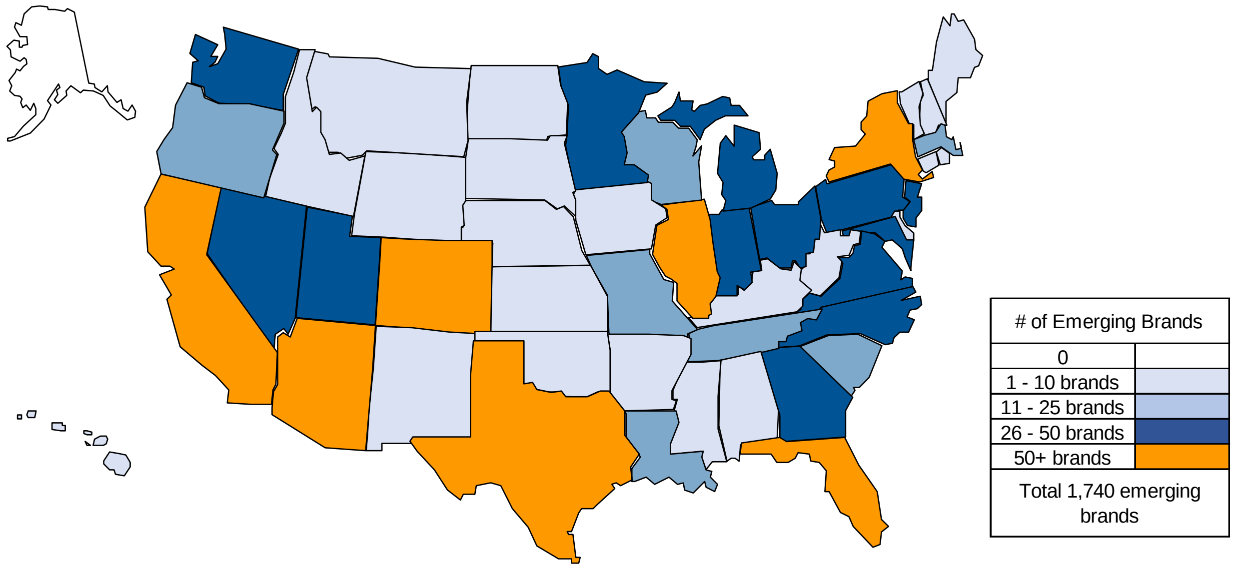


Overall, 27% of emerging concepts offer mobile or home-based businesses. New children's education franchises are increasingly offering mobile or hosted concepts that operate out of existing shared spaces – such as schools, community centers, churches, and other public and private space – as opposed to dedicated fixed locations. Through national and local partnerships, hosted businesses utilize existing facilities and spaces when they are not being otherwise used, eliminating real estate and development costs and reducing the overall startup timing. Some of these brands offer multiple investment options to franchisees, for both dedicated and mobile/hosted franchise opportunities, allowing the brand to establish a physical presence while enhancing its market coverage.

WHERE DO THEY COME FROM?

Most emerging franchisors originate from the western United States region, especially California with by far the highest concentration of emerging franchisors. Over a fifth of all emerging brands are headquartered out of California, followed by Florida with 8% of emerging brands and then Texas with 7%. Additionally, around 2% of emerging franchisors originate internationally, and are expanding into the United States, mostly from Canada.

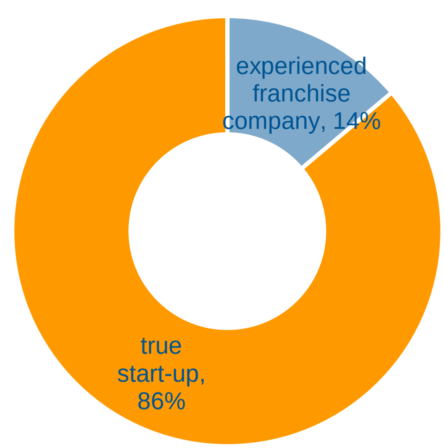
Emerging Franchisor Headquarters



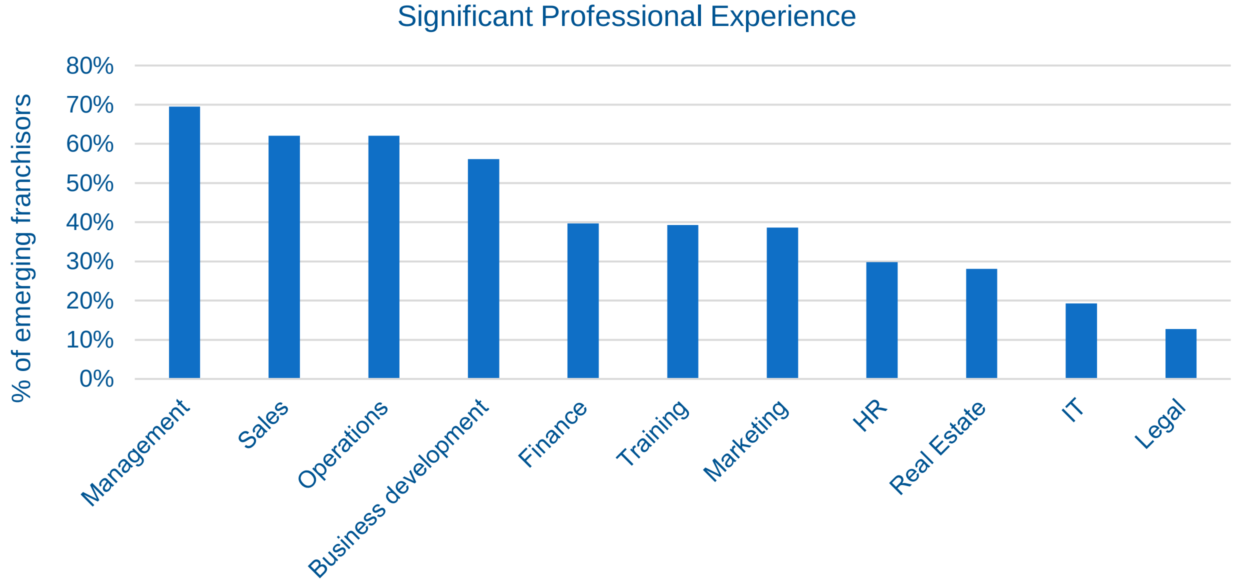
WHO ARE THEIR FOUNDERS?

Most new franchisors are true start-up small businesses when they start offering franchises. The majority are entrepreneurs and small business owners who are using the franchise business model to expand their small business to the next level. Of the 1,740 new brands that have started franchising since 2012, only 14% are established by existing franchise companies with big corporate backing, including international brands bringing their concepts to the United States, established franchise companies diversifying their portfolios and adding new brands, or companies with large corporate backing or private equity ownership.

Franchise Company Experience

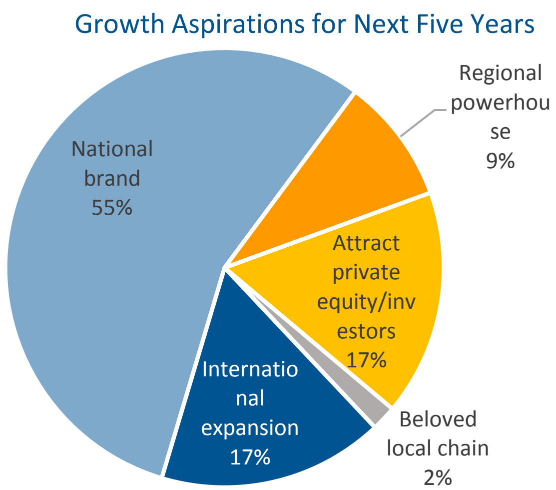


Small business owners come from many walks of life, some have extensive experience within the industry their business operates, others are entrepreneurial with business backgrounds. While most founders have some previous business experience, 62% of new franchisors don't have any experience with franchising prior to franchising their small businesses. Majority of the new franchisors are first time franchisors, but 13% own an additional independent business and 11% own another franchising company. Regardless of their experience, few founders of new franchise concepts embark on the endeavor alone – 24% of founders start their franchise business with a spouse, while another 45% have a business partner, to share the responsibilities and financial burdens of starting a new franchise organization.



WHAT ARE THEIR AMBITIONS?

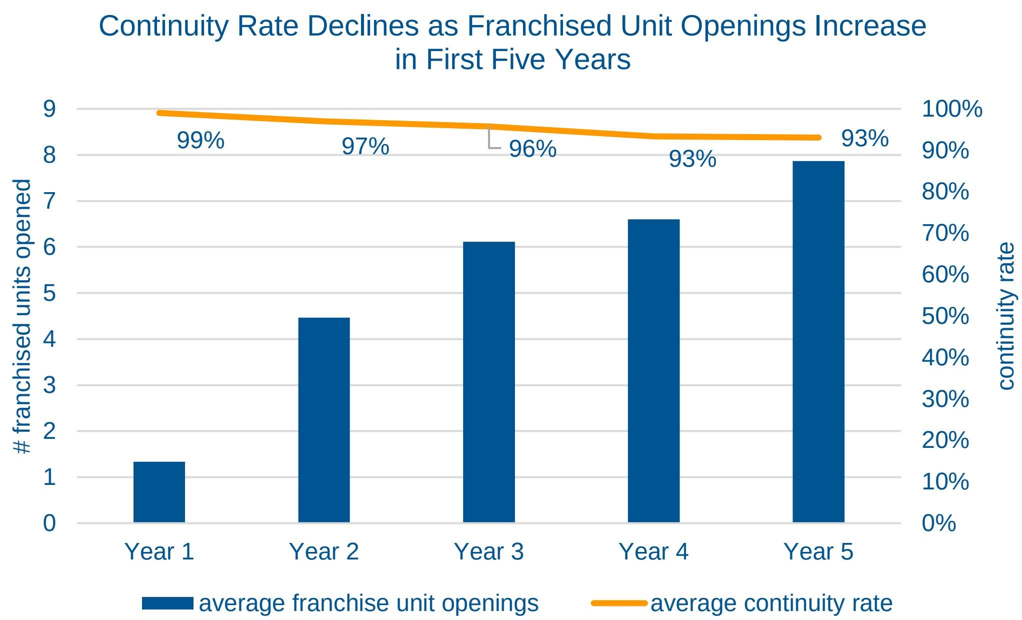
When making the decision to grow their business, 60% of founders considered other methods of growth including organic growth, expanding to alternative forms of distribution, and entering into partnerships or strategic alliances. In fact, many new franchisors tried other strategies, like licensing, before they ultimately moved into franchising. Over half of founders of emerging franchises said they chose the franchise business model because of the opportunities for faster expansion with lower corporate overhead, and lower initial capital investment. Based on this, it is not surprising that 72% of new franchises planned to grow their brand into a national or international presence within the next five years.



HOW ARE THEY PERFORMING?

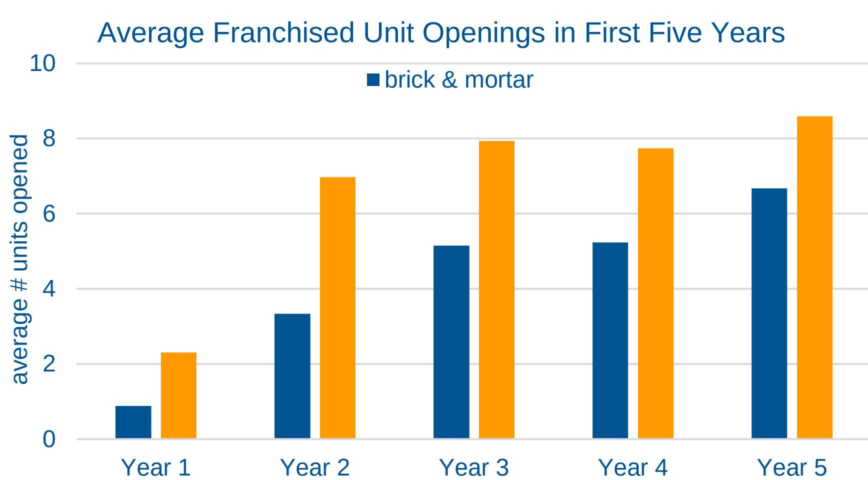
ARE THEY GROWING?

Emerging franchisors are eager to grow their system from the start. A common misconception is that the race to success is won by opening the most units, the fastest. There is no one size fits all growth trajectory, and a new franchise system's growth is dependent on numerous influential factors. In reality, emerging franchise systems open an average of 1.3 franchised units in their first year offering franchises, increasing to 4.5 units in their second year, and growing incrementally to an average of 8 franchised unit openings in their fifth year.



Opening businesses is only one side of the equation, keeping those franchisees and their businesses successfully operational is the second challenge. As new franchise systems open more businesses each year, the franchised system continuity rates decline, indicating that some of those businesses are not staying open throughout their first five years. In order to keep up with early growth, emerging franchisors must have sufficient resources and systems in place to support their franchisees, and ensure their mutual future successes.

The number of units a new franchise system opens each year varies greatly. In their first five years franchising, food brands generally open fewer units each year than nonfood and service brands. Food brands often require higher capital and can be riskier investments for prospective franchisees, limiting the pool of prospective investors to those who are financially qualified and have access to capital. Restaurants and other retail concepts also take a longer time to open because of the challenges involved in finding real estate, getting financing, obtaining all necessary permits, and developing the site to the brand's specifications.



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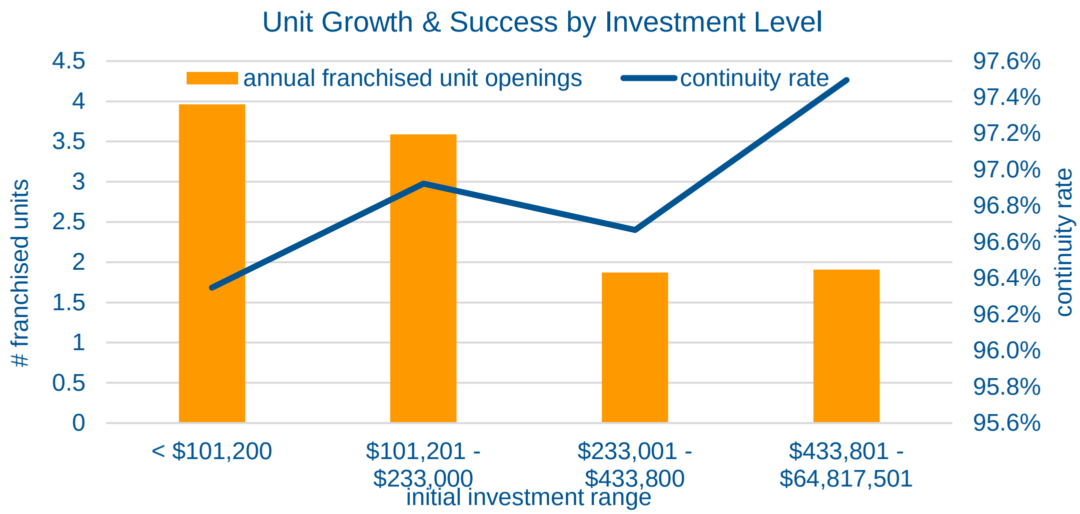
Concepts with low upfront capital requirements are more accessible to a larger pool of entrepreneurs, and generally faster to get the business operational. Forty-three percent of nonfood brands are mobile or home-based, making it easier to find franchisees and accelerating the time it takes for those franchisees to get businesses operational.



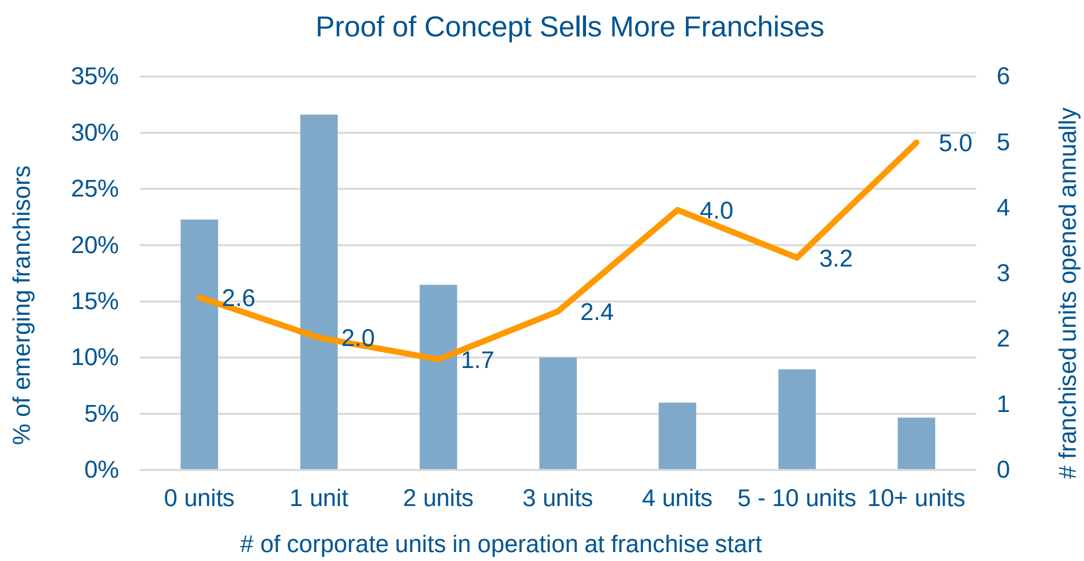
Similarly, concepts with higher initial investment levels are slower to open new franchised locations in their first five years. However, they generally keep those locations operational more consistently, while concepts with lower investment levels have lower continuity rates. In part, this is because businesses with lower initial investments can be easier to walk away from, often having limited assets and low inventory.

HOW ARE THEY FRANCHISING?

PROOF OF CONCEPT SELLS

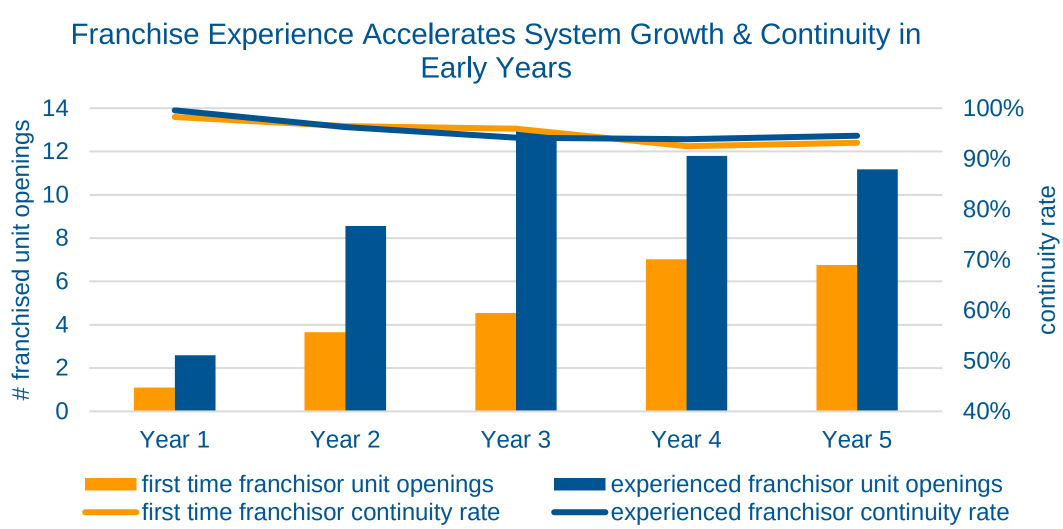
The path to franchising varies for founders of emerging concepts. Some emerging franchisors start a business with the intention of instantly offering franchises, while most decide to use franchising as a method to grow their existing business concept. The latter represents almost 80% of emerging franchisors that had at least one corporate business in operation when they started offering franchises for their concept.

Regardless of when they decide to start franchising, new franchisors understand the importance of entering the franchise market with a solid and replicable business. Establishing proof of concept to potential investors and franchise partners can be challenging for a new franchisor with minimal performance history under their belts. Most franchisors enter the market with a proven concept, having worked out the kinks in their existing businesses operations prior to offering franchises. Emerging franchisors have an average of 7.2 businesses in operation before starting to franchise their concept, ranging from zero operational businesses to several thousands.



On average, the founders operated their businesses for 7.4 years before offering franchises, during which time they establish business standards, create operations manuals, and implement systems for operating the business efficiently. Some emerging franchisors operated their independent business for over 50 years before deciding to offer franchises. Even those with significant years of operations learn that fine tuning and adjusting their business processes and system standards is an ongoing art that continues once they start opening franchised locations and expanding the system.

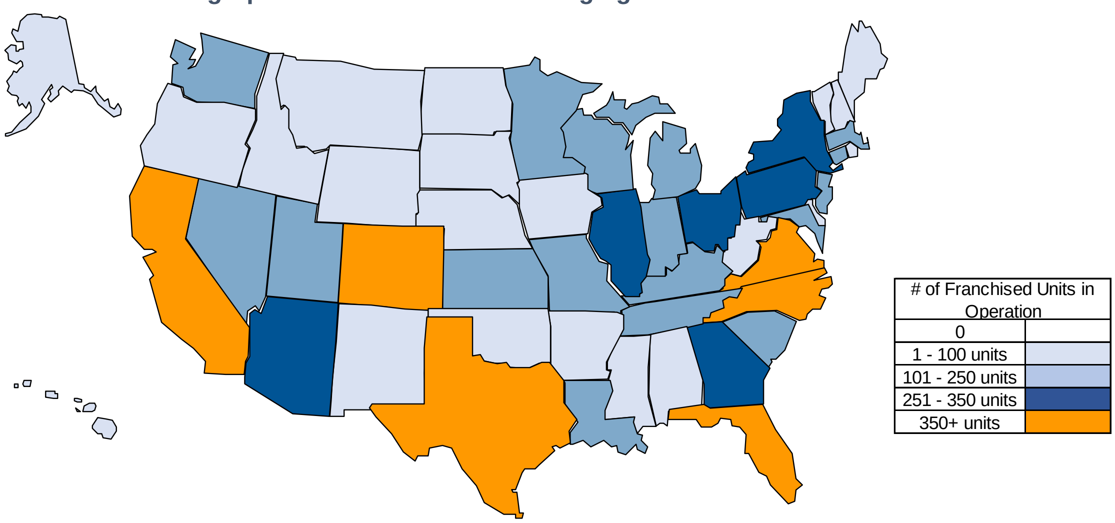
The 14% of new franchises that are started by established franchise companies diversifying their portfolios and adding new brands have a leg up over the true start-ups, as they can establish proof of concept and credibility through their existing franchise brands. These established companies are also able to leverage their experience, existing systems, and often even their network of franchisees to open over three times as many franchised units in their first five years, compared to true start-up franchisors. Experienced franchisors leveraging their experience and existing systems and standards, are also better equipped to provide necessary support to their new franchisee, maintaining higher franchise system continuity rates overtime.



WHERE ARE THEY GROWING?

Overall, the South and Western regions of the United States[1] have seen the most growth in emerging brands' franchised business operations, with 38% and 32% of the approximately 10,000 franchised units operated by emerging brands located in the respective regions. Emerging brands follow consumers, and are opening franchised units in the most populous states. California has by far the highest concentration of emerging brands' franchised operations, with 13% of emerging brands' franchised units nationally currently operating in the state.

Geographic Concentration of Emerging Brands Franchised Units

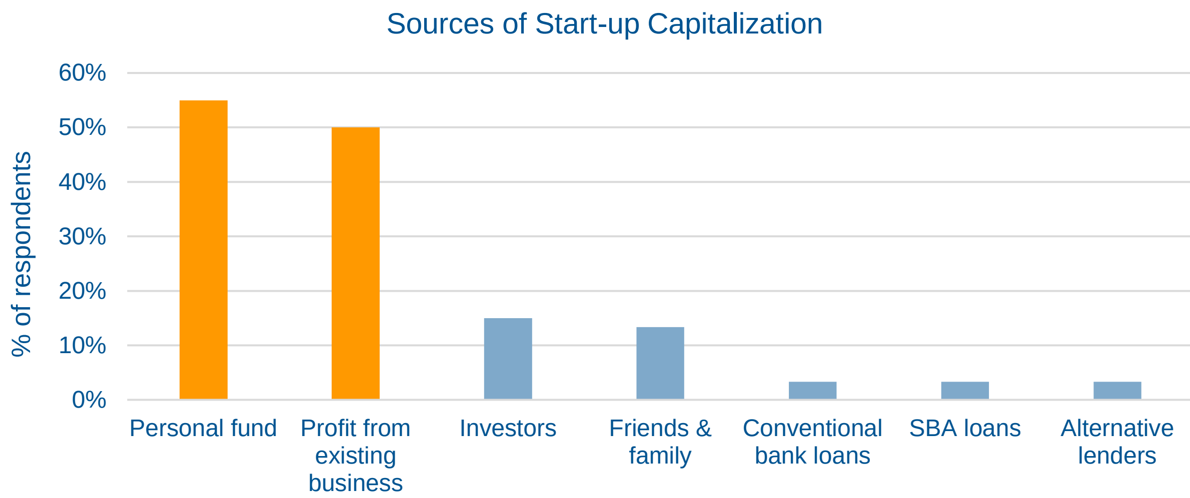


In their early years, emerging brands often grow geographically in the region the brand originated. This organic growth makes it logistically easier for emerging franchisors to provide support to their new franchisees. In their early years, emerging franchisors are still building their brand recognition and awareness, often making it easier to sell franchises in neighboring markets where they already have a presence. For example, of the over 500 brands that originated in the southern United States, 72% of their franchised units are currently located in the southern states. Similar is true for brands originating in the in Midwest, northeast and western regions, all having more than 50% of all of their franchised units currently operating in their respective region.

HOW ARE THEIR FINANCES?

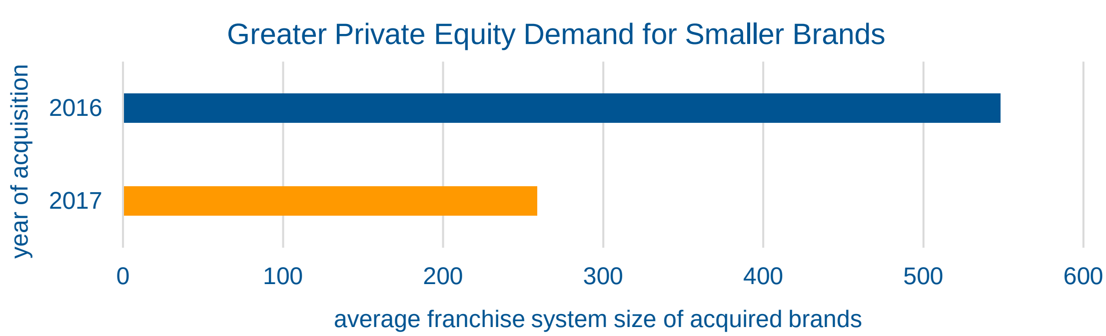
While the franchise business model is considered to be a less capital-intensive method of growth, strategic investments into the system in the early years are critical to its future success. To properly capitalize their new franchised business, 35% of new franchisors used multiple sources of funding to start franchising the business. Emerging franchisors are personally committed, with more than half digging into their own pockets to fund their new franchise business.

[1] Regions as defined by U.S. Census; South (AL, AR, DC, DE, FL, GA, KY, LA, MD, MS, NC, OK, SC, TN, TX, VA, WV); West (AK, AZ, CA CO, HI, ID, MT, NM, NV, OR, UT, WA, WY); Midwest (IA, IL, IN, KS, MI, MN, MO, ND, NE, OH, SD, WI); Northeast (CT, MA, ME, NH, NJ, NY, PA, RI, VT)



Knowing when and how to invest in an emerging franchise system is critical to setting up the infrastructure for future successful growth. Emerging franchisors are constantly reinvesting all incoming revenues, whether from franchise fees, royalties, or corporate store profits, back into developing their franchise system as they grow early on. Many who generate enough profits from their original small businesses invest those profits back into fueling the start-up and early growth of their new franchise system.

Private equity and other investment firms have developed an appetite for emerging brands. Competition for deals among private equity firms is at an all time high because of their growing arsenal of available funding. This competition is leading to higher company valuations, contributing to a seller's market. Private equity firms are increasingly shifting their focus to emerging brands, with younger and smaller brands are getting acquired by private equity before they mature.



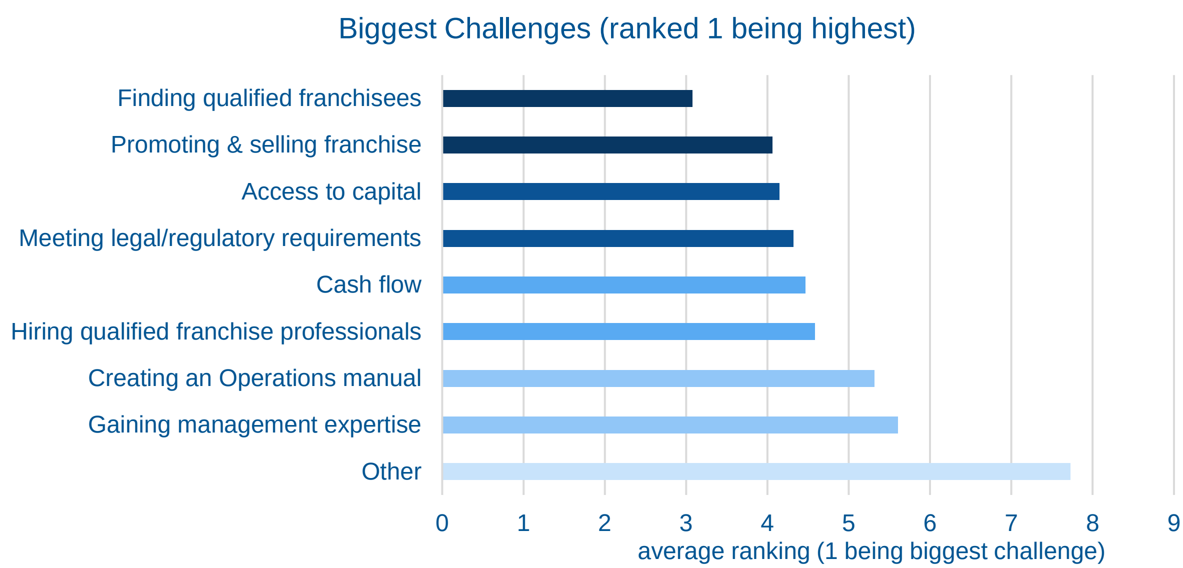
The discussion around break even isn't always clear cut for many emerging franchisors. Emerging franchisors often consider three phases in achieving financial stability. The first being breaking even, but more importantly, achieving initial profitability, and the third and true test of financial stability is achieving consistent and sustainable profitability. It takes many years for new franchisors to reach a stage of sustained profitability, but 61% of new franchisors achieve positive operating cash flows in their first five years franchising.

HOW ARE THEIR OPERATIONS?

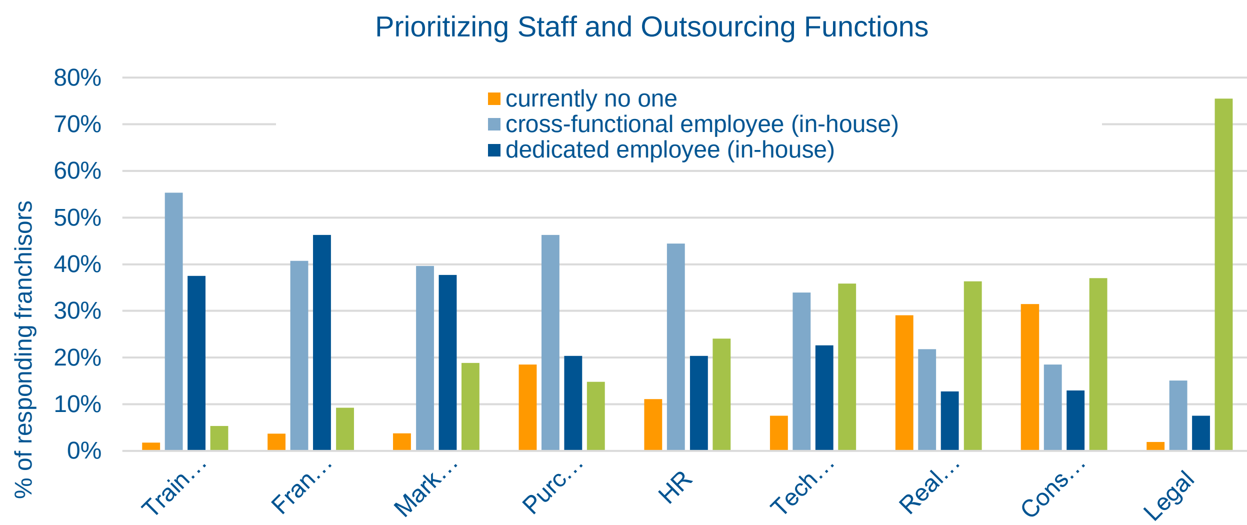
INVESTING IN AND SETTING UP THE ORGAZATIONAL INFRASTRUCTURE TO DRIVE SUCCESSFUL GROWTH

Emerging franchisors are in a unique position of opportunity, as well as challenge and consequence. The first few years of setting up their organizational and systematic infrastructure are crucial to framing their future growth and success. Emerging franchisors must be conscious about the system's future, while simultaneously learning and adapting to their new franchising business, and fine tuning their business operations.

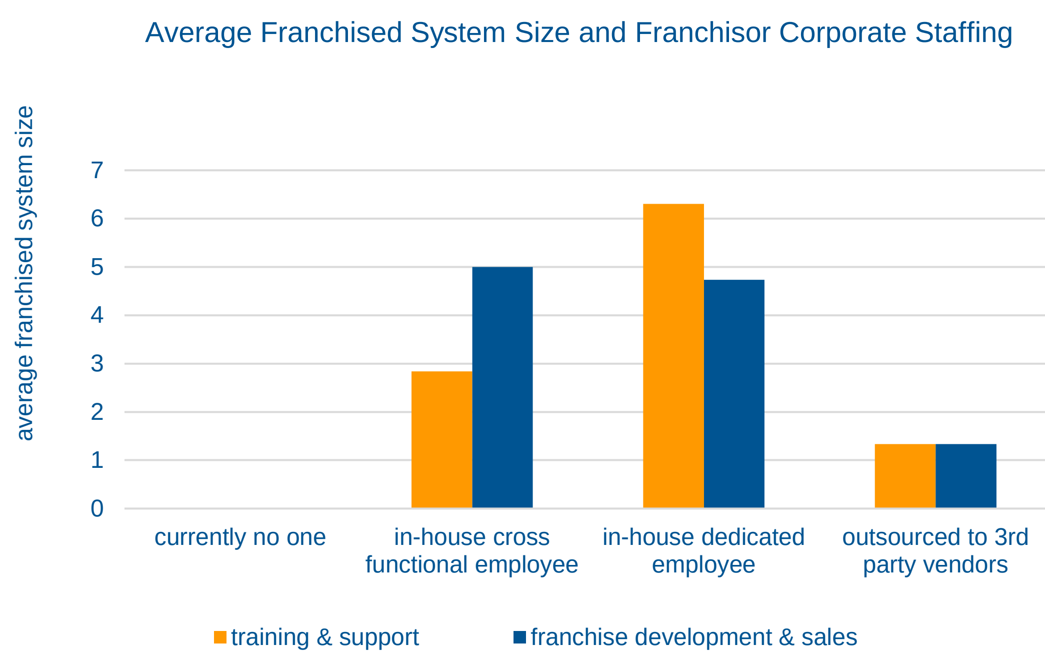
Emerging franchisors acknowledge that their biggest challenges are directly related to selling franchises. Emerging franchisors understand the importance of finding the right qualified franchisees to kick off their system growth, and that these first franchisees dictate the future success of their system.



Franchisors start with lean operations. New franchisors start with an average of 4.5 employees, who often wear multiple hats. Throughout their first five years, on average new franchise organizations add 3.4 employees to support their growing organization and system. In the first five years of growth, emerging franchisors have to be strategic in delegating numerous functions among limited employees. Emerging franchisors outsource certain functions to third party professionals to supplement their lean staffing. Franchisors are most likely to employ in-house staff for franchise sales positions, and franchisee training and support in their first few years franchising.



At the beginning, most franchisors prioritize franchise sales functions with a dedicated employee, while cross functional employees handle franchisee training and support. Half of emerging franchisors who sold their first franchise agreement in their first year franchising had a dedicated employee focusing on franchise sales, while 39% employed a cross functional employee who served multiple roles. The remaining 11% outsourced their franchise sales to a third party provider.



As the system grows adding more franchisees, the franchisor shifts to meet the needs of the larger franchisee system by hiring dedicated staff to focus their attention to franchisee training and support. Emerging franchisors who use cross functional employees for franchisee training and support roles have an average of 2.84 franchised units in operation. Once the system more than doubles, emerging franchisors with an average of 6.3 franchised units hire dedicated staff to focus on providing training and support to franchisees.

Emerging franchisors are often not equipped and don't have resources to assist new franchisees with the real estate support they need. In their early years, emerging franchisors have their plates full, and only 28% have previous significant experience with real estate. Recognizing the gap and urgency of the challenge to their young system, almost 40% of emerging franchisors plan to outsource the real estate functions and an additional 11% plan to hire an in-house professional to assist franchisees in finding optimal locations and speeding up the time it takes to develop and open their businesses.

CONCLUSION

For emerging franchisors, the key is keeping up with the system's early growth, which will depend on many factors, including the type of concept, investment levels, and the franchisors experience. Emerging franchisors make important strategic decisions on where and when to invest in their organizational infrastructure to promote the system's future successful growth. Usually starting by hiring a franchise sales professional to find qualified franchisees, new franchise organizations continue to reinvest every dollar their business makes back into supporting the system. Throughout their challenges and successes, new franchisors rely heavily on the franchise community and external resources to guide them through their early years of growth.

For more than 25 years, FRANdata has been the industry leader in the strategic analysis, forecasting and measuring of franchise performance and operations. Leveraging the largest database of franchise information in the industry, FRANdata helps any business that touches franchising by providing the objective information and analytical expertise they need to make smarter and better business decisions. FRANdata, headquartered in Arlington, Va., is often cited as a franchise expert in such leading media as The New York Times, The Wall Street Journal, Forbes Magazine and The Washington Post.

Powered by the FRANdata database, the Franchise Registry provides every franchisor the opportunity to make financing easier and better for their franchisees. Thousands of SBA and conventional lenders visit the site every month to find and learn about the franchise brands to whom they are considering lending. Besides publicly validating that a franchise is viable and thriving, the site allows franchisors to take advantage of such financing tools as the Bank Credit Reports, Enhanced SBA Loan Performance Analysis, and the FUND report helping lenders understand and underwrite the franchise brand.

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