ARITHMETIC 101
FOR PROSPECTIVE FRANCHISEES

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I.

The Capitalism Game

The capitalism game is played by trading money you have for something you want and vice versa. Success is defined as getting a good deal.

A. Grocery Store Example.

Assume:

1. You have $20 and want bread, milk, and eggs.

2. HEB and Kroger are each five blocks away. HEB sells bread, milk, and eggs for $7.00, and Kroger sells a different but similar set of bread, milk, and eggs for $6.00.

3. You are a knowledgeable, experienced buyer of bread, milk, and eggs from local grocery stores.

4. Other things being equal, you trade $6.00 to Kroger for the bread, milk, and eggs that you lack.

There is nothing immoral or mysterious about this transaction. You probably succeeded in getting what you wanted on the best terms, i.e., a good deal. This illustrates:

Rule No. 1. **Knowledge is power.**

B. Franchise Example.

Assume:

1. You have $100,000 in cash and the ability to borrow more if the loan is partly secured, and you can show the banker a credible business plan. You want to start a business that has the advantages of (a) a valuable trademark, (b) market power, and (c) expertise in that kind of business.

2. Many franchisors sell (a) trademarks, (b) market power, and (c) knowledge in this line of business upon wildly different prices and terms. You can also develop these on your own if you invest enough time, effort, and money to do so.

3. You have never purchased a business before, never purchased a franchise before, never managed a business of this type before, and probably never even worked in this type of business before.

4. Other things being equal, you buy a franchise from the franchisor you called first because you saw some of its successful franchises or responded to its advertisement. You do not thoroughly compare alternative lines of commerce, developing such a business on your own, or even alternative franchisors.

There is nothing immoral or mysterious about this transaction. You probably did not get what you wanted on the best terms. This illustrates:

<u>Rule No. 2.</u> **Lack of knowledge makes you the screwee.**

II.

<u>The Franchise Game</u>.

A. <u>General Observations</u>

1. There is nothing embarrassing about being stupid concerning a game you have not played before, as long as you do not try to play over your skill level. You become knowledgeable about a game by playing it many times. You are never stupider about a game than before you play it for the first time.

2. Your commitment to the franchise game is your fortune, family, reputation, and health.

3. Most prospective franchisees commit their fortunes, family, reputation, and health to the franchise game when they are at maximum stupidity.

B. <u>The Goal of the Franchise Game</u>.

Your goal in becoming a franchisee is to trade money you have for something you want but do not have, i.e., (a) a <u>powerful trademark</u> to attract the right kind of customers; (b) <u>buying power</u> to get the right location, equipment, building, suppliers, and advertising for the best price; and (c) <u>knowledge</u> about how to run the business most profitably . . . and make the best deal. The problem is you will never be stupider about how to play the franchise game than you are right now. You are at maximum stupidity.

The good news is this variety of stupidity is not necessarily a permanent condition. It can be cured by spending time and effort to get smarter. This is not expensive or hard to do. Buy some franchising magazines at the bookstore, look up ten franchisors in your desired line of commerce, and call them. Take a temporary job in the business to see what it looks like from the inside and see if you like it in practice as much as in theory. Join trade associations in the line of commerce to get their magazines. Go to the library and check out books about whether and how to get into this line of commerce; ask business owners in this line of business for their advice.

If you become focused on one franchisor, (a) call lots of its current and former franchisees, (b) compare its Franchise Disclosure Document (FDD with those of its competitors, and (3) call competitive franchisors and their franchisees. These things are all inexpensive and make you a smarter franchise game player who is more likely to get a good deal from the franchisor and succeed in the business. You owe it to your family and yourself to get smarter before you play the franchise game.

Rule No. 3. **Lack of knowledge can be cured.**

C. The Royalty * Revenue & Expense * Profit Relationship

Success or failure is determined by arithmetic. You must do alternative budgets with alternative assumptions to get a feel for the likely real drivers of your business' success or failure.

These examples compare a proposed franchise with an equivalent Independent Business with $100 in revenue and a 10% profit.

Example A

Assume a 10% royalty, a 10% gross profit, and that the franchisor's assistance does not help raise revenues or lower expenses

Franchise A	Independent Business
$100 revenue	$100 revenue
-90 expenses	-90 expenses
10 gross profit	10 gross profit
10 gross profit	
-10 (100 x 10% royalty)	
0 net profit	$10 net profit

This illustrates that the franchisor must either lower your expenses or raise your revenue to justify a royalty. You need to learn and understand these numbers in your investigation of alternative deals.

Example B

Assume a 5% royalty, a 10% gross profit, and the franchisor's assistance increases revenues 50% and cuts expenses 10%

Franchisee B	Independent Business
$150 revenue	$100 revenue
135 expenses (150 x 90%)	-90 expenses
$15 gross profit	$10 gross profit
15 gross profit	
- 7.5 (5% royalty)	
$7.5 net profit	$10 net profit

Example C

Assume a 5% royalty, and the franchisor's assistance raises revenue 25% and its requirements increase expenses 10%

Franchisee C	Independent Business
$125 revenue	$100 revenue
-100 expenses	-90 expenses
$25 gross profit	$10 gross profit
25 gross profit	
-6.25	
-$18.75 net profit	$10 net profit

Examples B and C show that you need to estimate how much the franchise will raise your revenue and lower your expense to justify the royalty.

Example D

Assume a 5% royalty, a 2% advertising fee and franchisor's assistance increases revenue 200% with a 10% gross profit

Franchisee D	Independent Business
$300 revenue	$100 revenue
-270 (300 x 90%)	-90
$30 gross profit	$10 gross profit
30 gross profit	
-21 (400.9.5%)	
$7 net profit	$10 net profit

This is the "McDonald's on an interstate highway" effect that franchisees often expect. Note the presence of the advertising fee, which, for this particular location, is money well spent.

Example E

Assume a 5% royalty, a 2% advertising fee and the franchisor's assistance increases revenues 50% with a 20% gross profit

Franchisee E	Independent Business
$150 revenue	$100 revenue
-120 expenses (120 x 81%)	-90 expenses
$30 gross profit	$10 gross profit
30 gross profit	
-10.5 [150 x (5%+2%)]	
$14.5 net profit	$10 net profit

Examples D and E illustrate that the franchisor's advertising fees must be included in your calculations because they can take a big bite out of your profit.

If "profits" are hard to get one's mind around when working with the above numbers in the abstract because you do not know what net profit margins to expect, try working the above examples with the average profits for a small business in your line of commerce. For example, automotive 12.4%, hotels, and motels 4.1%, restaurants 6%.

In a typical year, 75% of small businesses are profitable, and 25% are not. (A reason some firms with a "low" profit can do well is their investment is minimal. If, for example, a $1,000,000 investment creates a business with $10,000,000 in revenue, and a "low" net profit margin of 5%, then the return on capital is 50%!)

These examples are solely intended to get you to think about the iron grip arithmetic has on your business. To reflect reality more accurately, your business plans need to build in fixed and variable costs for your particular business to determine your break-even revenue. Revenue below this amount means you are losing money. Zero net revenue means you are losing money relative to holding down a job pumping gas at minimum wage.

Because of your huge commitment to the franchise, i.e., your fortune, family, reputation, and health, and because you will need an accountant to do your taxes anyway, you should review a preliminary business plan with an accountant before making an investment decision.

D. Franchised Business = Leased Business

A Franchised business is not entirely "your" business. It is only yours for a limited term of years, even with a renewal. At the end of that time, you are on the street. Further, the franchise agreement contains a non-competition covenant keeping you from operating a similar business for a term of years. In contrast, if an independent business is successful, you can sell it when you want to move on. Often, the primary profit that an owner pulls out of a business is upon exit, i.e., when you sell it. This difference can be significant in determining what the best deal is for you.

On the other hand, opening a franchised business rather than an independent business may give you better odds of remaining successfully open for five years rather than failing. The existence and extent of this "better chance to succeed" advantage for different kinds of franchisees and franchisors are hotly debated among franchising professionals and scholars. You should consider your facts and circumstances in determining how beneficial this factor is for you.

A big reason for entering a franchise system is to benefit from the franchisor's superior knowledge, hopefully derived from many years of riding herd on many franchisees. You may want to sell lottery tickets from "your" McDonald's restaurant for the crass reason that it will increase your sales of hamburgers as well as generate a profit itself. McDonald's Corporation – Big Brother – will say "No." Sometimes such franchisor instructions will save you from making a costly mistake, and sometimes the instructions will only cost you money. If you need to own your own business and need to manage it solely as you believe it should be managed, then being a franchisee will burn you out. You need to examine yourself and decide whether this aspect of franchising has more pluses or more negatives for you personally.

Rule No. 4. **Franchised Business = Leased Business.**

Additional articles concerning franchising can be found at http://www.jw.com/Mark_H_Miller.