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 $10 and want bread, milk, and eggs.

2. HEB and Kroger are each five blocks away. You check their ads. HEB sells bread, milk, and eggs for $6.00, and Kroger sells a similar set of bread, milk, and eggs for $7.00.

3. Your cost of personally producing bread, milk, and eggs from scratch is prohibitive.

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

5. Other things being equal, you trade $6.00 to HEB for bread, milk, and eggs.

There is nothing immoral or mysterious about this transaction. You probably succeeded in trading for what you wanted on reasonable 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 is likely to succeed because it has (a) a valuable brand, (b) market power, and (c) experience helping people like you succeed in that kind of business.

2. Many franchisors sell (a) a brand, (b) market power, and (c) expertise in the target line of business on 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 this type of business before, and never even worked in this type of business before. You do not methodically compare alternative lines of commerce, developing such a business on your own, or even alternative franchisors in that line of business.

4. Other things being equal, you trade money and promises to the franchisor who first impressed you in exchange for a franchisor's promises of a brand, market power, and experience in helping people like you succeed. [Version 2: Other things being equal, you buy a franchise from the franchisor you called first because you talked with some of its successful franchisees or responded to its advertisement. You do not thoroughly compare alternative lines of commerce, developing such a business on your own, or alternative franchisors for such a business.]

There is nothing immoral or mysterious about this transaction. You may not have gotten what you wanted on reasonable terms. This illustrates

Rule No. 2. Lack of knowledge makes you the screwee.

II.
THE FRANCHISE GAME

A. General Observations

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

2. Your first ante to the franchise game is all your chips: 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. The Goal of the Franchise Game

Your franchise game goal is to trade money you have and your promise of hard work for things you want, *i.e.*, (a) a powerful brand that attracts the right kind of customers; (b) market power that gets you the right location, equipment, building, suppliers, and advertising for the best prices; and (c) knowledge about how to run your business most profitably. You want to make a good deal. A problem is that you will never be stupider about how to play the franchise game than you are right now. You are at maximum stupidity.

Good news is that 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 franchising magazines online or thumb through them at a bookstore. Talk with five franchisors, ten franchisees, and five independents in your target line of commerce. Take a temporary job in the line of business. You may not like it in practice as much as in theory. Join trade associations in the line of commerce and read their publications and advertisements. Talk with the association's officers for advice. Ask non-competitive business owners in this line of business for their advice.

If you become focused on one franchisor, (a) call lots of its current *and form*er franchisees, (b) compare its Franchise Disclosure Document ("FDD") with its competitors, and (3) call competitive franchisors and their franchisees. These are all inexpensive and make you a smarter franchise game player. A smarter player is more likely to get a good deal and be successful.

A few years into being a franchisee, you will be a seasoned veteran. You will know what you should do to get a great deal if you had it to do all over again. You owe it to your family and yourself to do your homework and get smarter before you play the franchise game.

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

C. The Iron Grip of Numbers – Your Revenue, Expense, Royalty, and Profits

You need to learn and understand these numbers in your investigation of alternative deals. If your numbers don't work, it's a disaster.

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

Franchise A	Independent Business A
$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.

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 B
$150 revenue	$100 revenue
121.5 expenses (150 x 81%)	-90 expenses
$ 28.5 gross profit	$ 10 gross profit

28.5 gross profit	
- 7.5 (150 x 5% royalty)	
$ 21.0 net profit	$ 10 net profit

This franchisee is making more profit than a similar independent business.

Example C

Assume a 7% royalty, and the franchisor's assistance raises revenue 25% and raises expenses 2.5%

Franchisee C	Independent Business C
$125 revenue	$100 revenue
-115 expenses (125 x 92%)	-90 expenses (100 x 90%)
$ 10 gross profit	$ 10 gross profit
10 gross profit	
- 9.4 (125 x 7%)	
$- 0.6 net loss	$ 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 2.5% advertising fee, franchisor's assistance increases revenue 100% and, because rent and other fixed expenses are fixed, reduces your expense percentage by 10%

Franchisee D	Independent Business D
$200 revenue	$100 revenue
-160 (200 x 80%)	-90 (100 x 90%)
$40 gross profit	$10 gross profit
40 gross profit	
-14 [200 x (5% royalty + 2.5% ad fee)]	
$26 net profit	$10 net profit

This is the "McDonald's sign on an interstate" effect. Note the advertising fee, which is money well spent for a restaurant at this location.

Example E

Assume a 6% royalty, a 2.5% advertising fee and the franchisor's assistance increases revenues by 50%

Franchisee E	Independent Business E
$150 revenue	$100 revenue
-135 expenses (150 x 90%)	-90 expenses (100 x 90%)
$ 15 gross profit	$ 10 gross profit
15 gross profit	
12.7 [150 x (6%+2.5%)]	
$ 2.3 net profit	$ 10 net profit

Examples D and E illustrate that advertising fees need to be included in your calculations because they can take a big bite out of your profit.

These examples are intended to get you to think about the iron grip that arithmetic will have on your business and motivate you to run the numbers on your target small business. Your business plans need to build in expected, fixed, and variable costs to reflect reality more accurately. After these are determined, your break-even revenue point can be calculated. Zero net revenue means you are losing money relative to pumping gas at minimum wage.

If typical expenses and profits are hard to get your mind around when working with the above numbers in the abstract, try working the above examples with small business average profits in your target line of commerce. For example, automotive 12.4%, hotels, and motels 4.1%, restaurants 6%. Some businesses with a "low" profit margin can do well because their investment is small. If, for example, a $1,000,000 investment creates a business that has a revenue of $10,000,000, and a "low" net profit margin of 5%, then the return on capital is 50%!

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 your franchise purchase with your accountant and create a business plan before making your investment decision.

D. Franchised Business = A Leased Business; A Franchise Is Not Entirely "Your" Business

A reason for entering a franchise system is to benefit from the franchisor's superior knowledge, derived from its 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 restrictions will save you from making a costly mistake, but sometimes they will mainly cost you profits. If you need to manage *your* business solely as *you* believe it should be, then being a franchisee may burn you out.

All businesses get sold. Yours will be sold when you are vertical or horizontal (alive or dead). Often, the owner's primary profit, other than maintenance level income, is upon exit, *i.e.*, when you sell it. The business you sell is subject to its franchise agreement, profit-sucking royalties, and expansion limitations when your franchise agreement's non-competition covenant keeps you from operating a similar business for years.

In contrast, you can sell an independent business when you want to move on. This difference can be significant in determining what your best deal is.

On the other hand, opening a franchised rather than an independent business may give you better odds of success. The extent of the "better chance to succeed" advantage concerning different kinds of franchises and franchisors is hotly debated among scholars. You should consider your facts and circumstances in determining how beneficial this factor is for you and how much in royalties and limitations you should pay for it.

Do the benefits outweigh the costs? You should examine yourself and decide whether this aspect of franchising has more pluses or more negatives for you personally.

Rule No. 4. A Franchised Business Is Not Your Business. It's a Leased Business.

III.
FRANCHISING MYTHS VS. REALITY

A franchisor sales myth is that committing your money, promises, and family to a franchise is a secure investment. The reality is that the best guess of some informed commentators is that only one out of five first-time franchisees/first-time business owners of young franchisors are successful after five years.

How is this possible? First, when you see the many franchised businesses as you drive down the street, you don't see the ones that failed or will fail, or that sold or will sell at a loss. Second, most franchised businesses you see have been there for many years or are additional units opened by experienced multi-unit, well-capitalized franchisees with business ownership experience. Franchisor salespeople repeat rosy statistics, but poorly seek independent franchisee failure/sold at a loss data.

Third, the franchisee failure rate for young and inexperienced franchisors is much greater than for established franchisors. Established franchise doors have more typically learned from their rookie mistakes years ago. Young franchisors are still making them, at their franchisee's expense. Only one in five new franchisors survive five years.

Finally, poor management, a bad location, and undercapitalization will kill any business. Experienced franchisors screen out undercapitalized and awful businesspersons. They select well-capitalized, good, capable prospects. Such franchisees are a cherry-picked group likely to succeed with or without franchisor assistance.

What is success? A substantial portion of business owners make a reasonable living from their business while running it and make their fortune when they sell it. An equivalent independent business may sell for substantially more than a franchise because it is not burdened with royalties and restrictions.

These facts don't make buying a franchise a bad investment. A powerful brand, market power, expert assistance, and group buying power may make a particular franchise a good bet for you and help you be successful. These curmudgeon's perspectives here, however, should motivate you to do the hard work of researching, comparing, running numbers, and analyzing needed to keep your family from becoming roadkill.

More information about franchising can be found at https://www.jw.com/people/mark-miller/