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Franchising 2008 – crunch time: Challenges and opportunities

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By Jacqui Walker

This year could be crunch time for the \$125 billion franchising industry.

Low unemployment and the skills shortage have made recruiting franchisees difficult, and there is no sign of this easing. At the same time, interest rates are rising and the US sub-prime crisis is increasing the cost of capital and threatening to dent consumer spending, all of which could spell more sluggish sales for franchise chains.

But franchising is a resilient business model and offers many small businesses stability, systems, buying power and brand strength that could give them an edge over independent retailers and service businesses in a slowing economy. And there are still some services and sectors with good growth potential.

The past four years have brought good times for the franchising industry, with industry revenue growing at an annual average of more than 11% to reach \$125 billion in 2006, up from \$87 billion in 2003, according to the latest research from IBISWorld.

Nevertheless, some of the most vulnerable concepts and chains that have failed to grow over the past couple of years are likely to struggle.

And in 2008, the regulators have trained their spotlight on the sector. Both the West Australian and South Australian governments have ordered wide-ranging inquiries into the franchising industry in response to loud criticism from disgruntled, and net-savvy, franchisees about franchisors' unconscionable conduct, unfair trading practices and the corporate watchdog's failure to do anything about it.

On 1 March 2008, the long-awaited changes to the mandatory Franchising Code come into effect.

The outlook

The challenge for franchising, says Rod Young, executive director of franchise adviser DC Strategy, is to understand that marvelous economic times don't last forever. "Franchisors have to be managing for a softening in the economy," he says.

"In Australia, there are too many networks being franchised from a marginal basis. This is OK in good times. But now Australia has over 1000 networks. Those taking a me-too approach are going to be really challenged."

Franchisee recruitment is getting tougher as each chain loses on average 15% to 20% of its franchisees each year through natural attrition. Not only must these franchisees be replaced, but the chains must find new recruits to keep growing. For the smaller chains this is getting harder, and it is certainly more expensive.



A survey of 75 franchisors in October 2007 by marketing researcher 10 Thousand Feet found that the cost per acquisition of a new franchisee was \$16,304 and franchisors with less than 50 franchised units spent 24% more to acquire new franchisees than franchisors with 50 or more franchised units.

The study found that the industry spent \$44.4 million on marketing to prospective franchisees in the year to 30 September 2007.

Consolidation and acquisitions

All signs are pointing toward further consolidation in the industry. The trend is underway with the most prominent example the spectacular growth by the ASX-listed Retail Food Group. The company, which owned BB's Cafe and Dunkin Donuts at the time of its listing in June 2006, has since acquired well-established Brumby's Bakeries and Michel's Patisserie chains.

Its share price hit a high of \$2.10 in November before the US sub-prime inspired sharemarket volatility hit. On Friday it closed at \$1.50.

Retail Food Group now boasts more than 1000 stores and recently announced a profit upgrade. Many franchise industry observers say that the company is on the right track. It is not the only one in the market looking for acquisitions, but so far it has acquired complementary franchised businesses.

By contrast, other parent companies of franchised businesses with fewer obvious synergies have had a rockier road.

The ASX-listed Retail Cube (owner of retail chains King of Knives, Amazing Paints and Athletes' Foot) issued its initial shares in July 2004 at 50 cents. Nearly four years later, on 25 January, its shares closed at 27 cents. Allied Brands' share price (the owner of Baskin Robbins, Cookie Man, Kenny's Cardiology; and soon Awesome Water) has increased in the past year from 30 cents to 56 cents on Friday. But in 2006 it dipped to 8 cents. The company issued its shares at 35 cents in 2004.

Many of the recent acquisitions by franchise chains have been funded by private equity. The US sub-prime crisis has increased the cost of capital and most in the industry agree these deals are going to be harder to do in 2008.

Nevertheless, there are many still on the cards. Young says he can't name names, but he is talking to two larger networks about buying their competitors, funded by private equity.

Which chains are most vulnerable to a slowdown?

If interest rates continue to rise and demand softens, those franchise concepts most exposed to discretionary spending are likely to be the first to feel the heat. Some say that chains in some of the most crowded markets, like coffee retailing and fitness, could come under pressure.

And rising interest rates are likely to affect demand for mortgage brokers. Over the past decade the franchised mortgage brokers have experienced boom times. Mortgage Choice, RAMS and others have expanded to meet the demand for credit from the proliferation of non-bank credit providers.

The recent volatility in the sharemarket, the rising cost of credit and concerns about lenders exposure to US sub-prime mortgage risks is likely to drive a flight to quality. If borrowers are going straight to the banks they may be less likely to use a mortgage broker to find them a lender.

Multi-unit franchising as the answer to recruitment problems

With strong wages on offer for employees, the incentive to take a chance on a franchise is not as great.

John O'Brien, the chairman of the industry body Franchise Council of Australia, says that "2007 was the leanest year for franchise inquiries in 10 years".

He says franchising relies on people wanting to make a big sea change in their life to improve their standard of living. "Now people are so well looked after they are not considering such a jump as much."

The difficulty in recruiting franchises that will intensify in 2008 will further encourage the franchise chains wanting to grow to a

multi-unit franchise. They will continue to offer more than one territory to existing franchisees. It's a strategy that has helped build big chains like Subway very quickly.

Availability of credit

The Franchise Council's O'Brien denies that the banks are closing their purses to investment in franchising. On the contrary, he says that franchising is perceived by banks as a safer investment than independent small business and many are lifting the rate of their unsecured lending to between 40% and 60% of the loan to franchisees.

"What I'm seeing, this time round, is that the banks are more sophisticated in micro-management of their debt books. The feedback I get is that they find this sector safer relative to other small business."

Disputes

The increased publicity disgruntled franchisees are creating is not helping the franchise industry in its recruitment drives, admits O'Brien, although he maintains that the rate of disputation in Australia remains low. "Due to effective use of the internet, those people who are disaffected have a way to get their message out there. They are marketing more effectively."

In 2007 several high profile chains found themselves mentioned in the media or in Parliament in connection with churning and other unsavoury or unconscionable business practices. The international bakery chain Bakers Delight, car care franchise Midas and poultry chain Lenard's are three that have been singled out for special attention.

The unhappy former franchisees have been heard by the politicians and policy makers and a review into the federal Franchising Code which governs the sector was carried out in 2007. The Howard government responded to its findings with amendments to the mandatory code, which will come into effect on 1 March 2008.

Increased disclosure obligations

Most franchise observers say that the amendments to the code do little more than codify best practice which the best franchise operators were following anyway. But Jason Gehrke, director of franchise consultancy Franchise Advisory Centre (and SmartCompany blogger) says that many franchise chains will have to do some extra work to comply.

Two of the most controversial changes include the new obligation to disclose to potential franchisees the contact details of former franchisees, and the obligation to disclose to prospective franchisees a list of suppliers that pay to franchisors a rebate for goods purchased by franchisees.

Gehrke says he is recommending his clients to set up an alumni association for past franchisees. "It's now as important to retain the relationship with franchisees after the end of the franchise agreement as it is before the agreement is entered, because past franchisees can have an impact on the success of the franchise."

State franchise inquiries

The changes to the Franchising Code may not be the end of regulatory change for the franchise sector in 2008. Western Australia and South Australia are running inquiries into the sector.

Some in the sector fear that this could lead to another layer of regulation in those states in addition to the federal code. But Gerke is more optimistic. He believes this could be an opportunity for additional government support for the sector.

"There could be some wonderful initiatives to come out of these inquiries, through state development corporations for example. They may recognise the opportunities to provide a facility of pre-entry to franchising education, business mentoring and ongoing professional development for franchisees and franchisors," says Gerhke.

The Franchise Council of Australia is on the record as being anxious about more costly regulation resulting from the inquiries. But chairman O'Brien is optimistic that the new Rudd Government will work with the state Labor governments and the others to reduce red tape and over-regulation in many areas for small and medium businesses.

"Rudd has said, quite rightly, that there is the opportunity for alignment. I believe some of the heat and energy generated by the inquiries might have dissipated because those states will now have more opportunity to work with their federal

counterparts.”

“[Prime minister] Rudd and [Small Business Minister] Emerson are giving signals that they are open to working with the sector in the area of education in particular to avoid some of the issues that might have prompted issues in the past.”

New opportunities

The emerging sectors in franchising in the past couple of years have been fitness and health. If economic conditions stay solid, these concepts are expected by many to continue to grow in 2008.

“It’s not just gyms,” says O’Brien, “Personal trainers, health and beauty, waxing for men and women.”

There could be more opportunities in rural areas for franchising too. “As we finally see the drought easing, and hopefully breaking, there are probably a dearth of franchise expansion in rural Australia.” Seed franchises, agronomy, and fencing franchises are likely to do better. “There are some overseas concepts that haven’t arrived yet.”

Some education services franchised businesses are experiencing good growth as well. Franchises that provide in-home care service to elderly people in their homes such as Home Instead are considered to have plenty of opportunity for growth.

Export

Overseas expansion continues to be a growing trend for Australian franchises. The FCA is taking its biggest ever delegation to the international franchise convention in the US in 2008. About 20 brands will be represented.

Rod Young says there are fabulous opportunities for Australian franchises to go global. He is advising a number of chains.

One, Just Cuts hairdressing, has just opened its first store in India. He says that many local chains have a business model that can be successfully adapted to overseas markets. The US, Britain, India, China and Malaysia are increasingly popular destinations.

“And there are growing opportunities in South Africa and the central European states,” Young says. Juice franchise Boost Juice has just sold a master franchise for Estonia and Latvia. Boost’s highest volume store is now in Britain. Cookie Man’s highest volume store is in India.

Gloria Jean’s Coffees is another chain that is making the most of overseas opportunities.

The last word

John O’Brien says: “The Franchise Council members know that it could be a tougher year ahead. [But] the bigger organisations have the ability to close ranks and prepare if they need to.”

And entrepreneurs will not be stopped by a slowing economy he says. There are always enterprising business owners looking to franchise.

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