

Nicola Broadhurst, head of franchising at Mondays sets out her blueprint for selecting franchisees

## THE BLUEPRINT FOR CHOOSING FRANCHISEES

Whilst the success of a franchise network depends on a number of factors, one of the most important is the recruitment of the right franchisee.

A common pitfall particularly among new franchisors is the tendency to grant franchises to the first people to show an interest, without ensuring that they have the appropriate qualities to make a success of the business. Very often the qualities that a franchisor believes are vital for success at the beginning turn out to be completely different when put into practice.

As a franchise network develops and matures a detailed and specific criteria is usually established for the selection of franchisees. This is based on the experience and possibly earlier mistakes. In some cases the selection process can be extremely rigorous with many interviews with the prospective franchisee taking place before the franchise is granted. It is a prudent franchisor, however, who takes the time at the outset to try and at least establish an outline franchisee profile, which can then be adopted.

### The foundation for the franchise profile

Although each franchise business requires specific abilities, there are, however, basic qualities which all franchisors should look for in their prospective applicant which will form the foundation of any franchisee profile. Once the foundation is in place additional qualities can be specified, depending on the type of franchise and, for example, specialist knowledge, technical know-how and vocational qualifications. The starting point for any initial franchisee profile, however, can be broken down into the following six broad categories:-

- *Health*
- *Experience*
- *Ability*
- *Financial resources*
- *Integrity*
- *Compatibility*

### **Health**

It is obviously of vital importance that any prospective franchisee is in good health. The vast majority have to work extremely hard and anti-social hours to build their business up to a sufficient level to earn them a comfortable standard of living.

Given that many franchisees may not have owned a business of their own prior to joining a franchise, the stresses and strains of running and managing their own business can be considerable. A franchisee must be able to cope with the pressures that will be put upon him. In addition, the nature of the business concerned may call for a high level of physical activity and stamina, such as that needed to carry heavy loads, stand all day, or work in difficult conditions.

As it is often perceived by franchisors as one of the main advantages of franchising that franchisees will be more committed and spend less time off sick than an employee, it is surprising how often health is overlooked.

Whilst it is often a provision of the franchise contract that relevant insurances are in place to cover business interruption due to illness or incapacity, any such interruption will obviously have a detrimental effect on the business if it continues for long enough. Even a commonplace problem such as recurrent migraine or asthma attacks can become an issue if it results in a number of days on which the business cannot be operated.

There are a small number of franchisors who will require their prospective franchisees to undergo an independent health check before they are accepted, but this is certainly in the minority. Understandably such checks may meet some resistance from applicants, but at the very least questions should be asked. Unfortunately this is an area that is often not considered or underestimated.

## ***Experience***

With the exception of those franchises which require specialist skills or vocational qualifications, many franchisors do not require their prospective franchisees to have previous experience of the business. This is seen as a positive factor.

Most franchisors believe that their task of training a franchisee is much easier if they do not have to re-train the person in a method of doing something - old habits die hard. Some franchisors specifically exclude from their franchisee profile applicants who do have prior experience of their business for this reason.

One of the key elements of any business-format franchise is consistency and uniformity of services and products. It is essential, therefore, that each franchisee is trained in exactly the same way and carries out the business in a similar manner.

## ***Ability***

Having received the relevant training a franchisee must have the ability to put this into practice and make a success of the business. In determining ability, franchisors will obviously look at personal characteristics such as self motivation, commercial acumen and independence. Whilst a degree of independence on the part of the franchisee is necessary to make the business successful, there is a delicate balance to be struck.

Franchisors will not want their franchisees to be complete drones who are solely reliant on them for advice and instruction. Too little initiative can be a drain on resources if the franchisee is in need of constant supervision and encouragement. However, a franchisee who is too single minded can well turn into a nuisance to the network in general, constantly at odds with his franchisor and challenging the procedures which form the system.

Increasingly franchisors are relying on external methods of evaluating characteristics, such as psychometric tests, in order to attempt to define the most appropriate personality for the franchise network.

## ***Financial resources***

It is usually a requirement of a franchise agreement that the franchisee has adequate capital resources to run the business effectively. Each franchisor will have its own requirements for what it considers to be the minimum amount of finance and it is useful to include this stipulation in the franchise agreement.

It is often an advantage from a franchisor's perspective that franchisees are a little hungry financially. Regular loan and interest payments tend to be an incentive to a franchisee to do well. If, however, a franchisee has borrowed too much he may well become demoralised.

The loan-to-capital ratio is usually determined by the bank or other financial institution committed to assisting the financing of the franchise network. In this case the strength and success of the franchisor and the network will be a guiding factor.

## ***Integrity***

It is vital that a prospective franchisee is open, honest and trustworthy. Most franchisors derive their income from a continuing franchise fee which is usually calculated as a percentage of the gross turnover of the franchisee's business. Others receive their income from a mark-up on the goods that the franchisees are contractually obliged to buy from them.

In determining the correct fees franchisees are often subject to detailed accounting and reporting procedures, both in the operations manual and the franchise agreement. Mechanisms are usually included to determine the accuracy of the financial accounting, including a right of inspection with little or no prior notice to audit the accounts and the right of the franchisor to recover the costs of such audit if a discrepancy is found.

A margin of error is often provided for before the franchisee becomes liable for the cost of an audit, but this is usually small, e.g. 2-5 per cent.

No matter how sophisticated these systems are, however, it cannot prevent a deceitful franchisee from under-reporting his turnover, or fiddling the books.

In an ethical franchise there must be implicit trust between a franchisor and franchisee, both acting in good faith towards the other, for it to succeed. Rather like an employment relationship, a breakdown in the franchise relationship is likely to ultimately result in termination.

Franchisees are often subject to a heavy duty of disclosure and it is usually a term of the franchise agreement that where a franchisee has failed to disclose anything which may be material to the franchisor then the agreement will be terminated. There is no reason why franchisors cannot place searching questions on their franchisee application form, subject to the normal confidentiality provisions and they should always take up references where possible.

## ***Compatibility***

At the end of the day, a franchisor has the ultimate discretion of whether to accept or reject an application. Sometimes this decision is simply based on gut instinct.

Compatibility is a difficult term to define and an element of intuition is always involved. The franchisee may fit the profile perfectly, but a franchisor may still feel that he will not be able to do business with him over a prolonged period of time. It is a rash person who ignores such instincts.

## **Methods of recruitment**

A number of different methods are used by franchisors in recruiting new franchisees. According to the latest NatWest/BFA annual franchise survey a significant number of franchisors report that magazine advertising is the leading source of franchisee recruitment and this still remains one of the most popular recruitment tools.

The internet is increasingly used to advertise for potential franchisees. Often this is the first place prospective applicants will search for specific information about their chosen franchisor and more generally for a franchise opportunity to acquire. An impressive website with accurate up-to-date information can only serve to enhance the profile of a franchisor.

Franchisors, however, appear to be finding it increasingly difficult to recruit suitable franchisees. Another problem is the length of time taken to sign franchisees and ensure the units are operational. On average, it takes six months for newly-signed franchisees to start working, according to the survey.

To counteract these difficulties some franchisors seem to be broadening their recruitment criteria and have stopped specifying particular characteristics, such as an age range or gender. This may well not pose any problems, but the qualities discussed earlier will still need to be present with self motivation topping the list in order for a franchisee to succeed.

## **Dealing with problem franchisees**

It is important that the franchise agreement provides ways in which unsuitable franchisees can be removed from the network, but without being so heavy handed, or one-sided that the agreement is seen as unreasonable. This is often a fine line.

A well-drafted agreement should not only provide the right at the outset for the franchisor to terminate the agreement, either during or immediately after the initial training, should the franchisee be sub-standard, but also the right to monitor their performance on an ongoing basis. Should the franchisee fail in a material way to exhibit the required qualities the franchisor should then have the right to terminate. A franchisor has to act carefully, however, in attempting to terminate the relationship where a franchisee has failed to live up to its expectations.

If termination occurs during the initial training period, then it would be contrary to the BFA's code of ethics for the franchisor to retain the franchise fee in its entirety. This must be refunded, less any expenses and costs incurred by the franchisor.

## **Performance**

It can be useful to set minimum performance criteria as a benchmark of a franchisee's performance. The difficulty is in choosing appropriate goals, particularly where the franchise network is in the early stages.

The most common criteria is a minimum level of gross sales, either quarterly or annually. These figures should be based on the franchisor's actual experience and be realistic.

In the event of failure, the franchisor can then reserve the right to terminate the agreement. In order to avoid any dispute or counterclaim it is important that the franchisor ensures that it has met its own contractual obligations in respect of advice, support and assistance before relying on this provision.

A franchisor should have attempted to motivate and help the franchisee to perform better before taking this drastic step.

From the franchisor's point of view, a franchisee's failure through lack of performance can often have an extremely negative impact on the network as a whole. Not only can it be demoralising, but it can also make the franchise concept unattractive to prospective applicants. This really is a last resort.

## **Bad health**

A franchisor may reserve the right to terminate an agreement where a franchisor is incapacitated for a long period of time. This period of time is often specified in the franchise agreement and a well resourced franchisor may also retain the right to appoint a manager to run the business in the interim although this can be a costly exercise.

It is important from a franchisor's point of view, particularly in service-related industries, that a franchisee does not allow his business to run down significantly. In practice, the franchisor will probably want to try and re-sell the business to a third party whilst it still has value, rather than terminate the agreement and lose the value of the business completely.

From a franchisee's point of view, this is also the most beneficial exit route in these circumstances as it allows the franchisee, or his estate, to recover some value from his investment. This is an area that has to be handled sensitively.

## **Lack of financial resources**

Any sound franchise agreement will require a franchisee to have adequate working capital and grant the franchisor the right to terminate the franchise agreement where a franchisee ceases to trade or becomes insolvent.

A responsible franchisor should be able to see the warning signs of financial difficulties well in advance and, therefore, should be able to move quickly in the event of insolvency.

Where it becomes apparent that a liquidator or trustee in bankruptcy is to be appointed it is important to seek expert advice at the outset to ensure that the franchisor's interests and those of the network are safeguarded.

## **Lack of Integrity**

Where a franchisee fails to provide accounting information, or consistently breaches the terms of the agreement, a franchisor will want the right to terminate. However, a franchisor has to act carefully as a court will often look unfavourably on a franchisor who it deems to have acted unreasonably.

It is usual to serve default notices on franchisees who are in breach, giving a grace period to rectify the breach concerned. These grace periods usually extend from seven to 28 days, depending on the breach concerned. Persistent breaches may be dealt with immediately, but again this needs to be specified contractually.

There are other circumstances which can be accommodated in franchise agreements, depending on the specific nature of the franchise involved, such as the retention of title in the products supplied by the franchisor, or the right to acquire the franchise premises. It is important that the franchisor seeks professional advice at the outset in order to ensure its interests are properly protected.

However, it must be noted that the exit of any franchisee from a franchise network, other than through the expiry of the franchise agreement or a resale, will always raise questions amongst the other members of the network and also potential applicants. In such situations, the franchisor's behaviour will be closely scrutinised for future reference not only by prospective franchisees, but also professionals, such as banks and lawyers, which could well affect the ongoing success of the network as a whole.

It is clear, therefore, that the choice of franchisee is crucial. Carelessness in the selection procedure can have devastating effects.

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