

## The conversion model

Franchising can be a good move for a business in a tough economic climate, but the business model has to be right from the beginning. Report: Tony Blackie

● There are more than 1500 franchise systems in Australia, operating in almost every business sector, and due to the tough economic climate many businesses have been looking at converting their operations to a franchising model.

Franchising often offers a solution for businesses looking to find new ways to expand, Professor Andrew Terry of the Australian School of Business at the University of New South Wales says. However, there are questions to be asked when considering a franchising model.

"First, can the business be franchised? Usually the answer is yes," Terry says. "In fact, any business that operates under management can be franchised.

"The second question is, should the business be franchised? Just because it can is not a good enough rationale. Due diligence is required to ensure that a franchise model will deliver the financial return it needs in order to survive.

"If the answer to the first two [questions] is yes, then the third question is, how will the business be franchised?" That is the most important question and there is no one way to do it."

There are infinite ways to go about modelling a franchise operation, Terry says. It comes down to understanding the market, evaluating and getting the balance right between the number of system-owned operations and fully franchised operations and then working out the financial structure. This includes how the franchises get their remuneration, whether through royalties, commissions, flat fees or profit share.

How much each franchise is expected to return to the system for management, training, marketing and the other centrally provided services forms the basis for differentiating franchising from other businesses.

Because there are so many ways to structure the process, Terry advises franchisors to work with advisers including franchising consultants, lawyers and accountants.

Evaluating the market is vital, as is understanding that not all franchises succeed. Terry says that Yum! Brands,

the largest food franchise operator in the world, has twice tried to enter the Australian market with Taco Bell without success.

"The most successful franchise systems will be developed over time," he says. "Steady and sustained growth is important if success is to be achieved. Having said that, the key principles of an agreement have to be in place at day one. Every franchise will evolve in terms of marketing and product but it is very hard to make changes to territory or contracts once you are some way down the track."

The recent high-profile failure of several franchise systems shows the importance of getting the business model right, the Franchise Council of Australia's executive director, Steve Wright, says. The collapse of the kitchen appliance retailer Kleenmaid Group, which was placed under the control of liquidators in May owing about \$102 million to creditors, and Kleins, the budget jewellery and accessories retail operation that is now in receivership owing more than \$25 million, represented the exception rather than the rule.

"[Kleenmaid's] model was not in the usual mould," Wright says. "They had a very high proportion of company-owned stores. When the bank looked at the business, the franchised stores did far better. In this model the franchisees did not own a share of profit and were on a royalty base. The franchisees were more like sales agents. Unfortunately, when the administrators moved in the operation could not work on a franchise model any longer."

Another example cited by Wright is the case of Samsara, a Brisbane-headquartered Asian furniture retailer. The operation got into difficulty and administrators were appointed in May this year. The company had a complex ownership structure and each of the

franchisees had a different agreement with the franchisor. This created confusing and difficult-to-manage arrangements.

However, others have found the establishment of a franchising model has saved their business and promoted growth.

Electronics supplier Strathfield Group went into administration earlier this year, Wright says, and it emerged as a franchised operation, selling off the various stores to franchisee partners and building on the network's established reach.

Another successful move to franchising was taken by Ella Baché, which had been a chain of retail outlets. Franchising involved, in many cases, the sale of outlets to the operators plus the addition of franchisee operations in new areas. This gave the operators a greater say in the marketing and structure of the operation.

Wright believes the franchising model stands out because it does not suffer as much in downturns. The co-operative nature of marketing and the ability to adapt business-to-market trends gives the model an agility for survival.

"Greater control over suppliers, over pricing, marketing and general flexibility is all done on a scale well beyond a stand-alone business," Wright says. "The network can support individuals when circumstances change."

Wright uses the example of bulky goods retailer Clark Rubber, which had many discretionary stock items such as swimming pools and outdoor furnishings. "They bought out three franchisees in stores that were not in good profitable shape and closed the stores. The franchisor took on more responsibility for the back office," he says. "They did the right thing to share the risk."

The company adapted the product and services range to match the market, he says, and the move paid off. "They have had the best four-month start to any year. Two of the stores have reopened."

Stewart Creighton, Commonwealth Bank of Australia's general manager for market specialisation, runs a large team of bankers dedicated to the franchising community.

"In challenging times, the business with a plan and tight financial and management controls will do better," he says. "But it is important to note that franchising will not make a bad business better. The fact is that running a franchise is far more complex than running your own stand-alone business. You have to manage your franchisees, who are often independently minded people who are running their own businesses; they are not employees.

Creighton says that the buying and selling activity within the franchise community is as busy as ever, with trends indicating food retail franchises at double-digit growth. **BRW**

