2013 FRANCHISING OUTLOOK

PERSPECTIVE

In a world of uncertainty, **franchising keeps proving it's a business model that works.**

Mark Fleischer

Despite many changes in the world of business, history continues to play an important role in franchising. In some industries, they talk about being on the frontier of disruption and in need of transformation.

That is directly opposite from franchising where proven is the byword. Investors like franchises because they are based on pretested business models and they come with operating plans and playbooks.

They also are closely aligned with local economies, which translates into more confidence. According to the National Center for the Middle Market (NCMM), respondents to its quarterly surveys consistently express confidence in their local economies. For the last quarter it was 71 percent, 20 points higher than the confidence level in the national economy.

These factors, along with consistently good quality products and services at affordable prices, are probably why private equity firms like Roark Capital and Bain have franchise investments in their portfolios. Roark has 19 franchise brands, 8,000 locations, and generates $4.5 billion in system

NATIONAL CENTER FOR THE MIDDLE MARKET

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sales. Bain has investments in Dunkin Brands, Gymboree, and Domino's Pizza Japan.

We recently talked with a commercial banker about his experiences with franchising. "I like them because I don't find myself in the position of trying to pick winners and losers. With franchising I can go with a proven brand and be assured the owner will have the support to be successful."

The symbiotic relationship between franchisor and franchisee starts at the financing stage. But it continues throughout the lifetime of the business.

In this era of Big Data, the franchisors and franchisees can analyze their numbers to better understand how to serve their customers, increase their sales, and decrease their expenses. They might even go back in history to mine the data for insights. FRANdata offers access to a 20-year archive on franchise brands, and the Coleman Franchise Report has SBA statistics since 2001.

Franchising has a great history and had a record-setting number of new units in 2012. However, the macroeconomic outlook for 2013 will continue to be sluggish and it will affect the industry. Predictions are that the number of new units and the number of jobs created will fall slightly short of last year.

However, there are new ways of dealing with the funding shortfalls that we've been seeing. You can perhaps put together a deal by combining the resources you can find online and a traditional bank loan. Or perhaps you can qualify for a special program with the franchisor.

Of course, those in the franchise industry are like all employers, they need to begin planning for the impact of healthcare's "play or pay" mandate that becomes effective on Jan. 1, 2014.

It is a complex issue, and there are no wrong answers, but you need to research your options and work with an advisor to model the scenarios you think will work best for you, then make your decision.

Here's to 2013, another year when franchising stays true to its reputation as a business model that works.

Regards,

Mark Fleischer
Franchising group leader

THANK YOU

FRANCHISING BOOT CAMP
National Football League
International Franchise Association
Ross School of Business, University of Michigan

MELANIE BERGERON
Board Member, International Franchise Association
Chair of Two Men and a Truck

DEE EDINGTON
Edington Associates

Tried and true franchise business models spell **relief in uncertain economic environment.**

IN 2012, THERE WAS A 1.5 PERCENT GROWTH IN FRANCHISE UNITS

Franchises had been closing their doors, one after another from 2008 to 2011 for a total loss of 23,000 establishments. But all of that changed last year. In 2012 there was a 1.5 percent growth in units — up from 746,828 to 757,055 for an increase of 10,227— according to the International Franchise Association (IFA).

Entrepreneur Magazine, which has been publishing the "Franchise 500" list for 34 years, paints a rosier picture. Companies on its list added 19,197 franchise units between 2011 and 2012, almost doubling the previous year's growth. Entrepreneur and the IFA also report anticipated revenue growth in franchising for 2012 at 4.9 to 5.2 percent, which is:

- On par with the middle market according to data from the NCMM
- Impressive when compared to the forecasted 3.5 percent rate of growth for the S&P 500, according to Bloomberg

Industry watchers credit the renewed interest in franchising

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with its appeal as a tried and true business model in an uncertain economic environment.

Business leaders can all agree uncertainty is bad for business. In mid-December 2012, 85 percent of CEOs predicted that even a negotiated settlement to the fiscal cliff would not end the uncertainty in Washington, D.C., according to indicators collected and analyzed each quarter by NCMM at The Ohio State University.

EIGHT OUT OF 10 FRANCHISORS PREDICT EXPANSION IN 2013

Further adding to their appeal, franchises are tied to local economies, and 71 percent of middle market managers are confident or have some confidence in their local economies. That compares to 51 percent for the U.S. economy and 33 percent for the global economy, according to fourth quarter data from the NCMM.

Perhaps it is this level of confidence that has eight out of 10 franchisors predicting expansion in 2013 when surveyed by the IFA in November 2012.

Private equity investors also seem optimistic. For example, as of last year Roark Capital had 19 franchise brands in its portfolio, which represents 8,000 locations and generates $4.5 billion in system sales. Bain has investments in Dunkin Brands, Gymboree, and Domino's Pizza Japan.

Despite all of this positive news, franchises are predicted to see a slight slowdown in 2013 with output of franchise establishments going from an increase of 4.9 in 2012 to 4.3 in 2013, according to the IFA.

During 2013, franchisees and franchisors can position themselves for more growth by tackling some of the ongoing challenges they face, such as:

- Creating synergy between franchisor and franchisee
- Planning for the impact of the Affordable Care Act (ACA)
- Seeking various opportunities for capital

ANOTHER VOICE

WHAT WILL YOU DO WHEN YOU RETIRE FROM THE NFL?

A team of powerhouses on the field and in business have combined their efforts to offer an intensive four-day "boot camp" for 20 former NFL players and their spouses, April 26-29, 2013, at the Ross School of Business, University of Michigan.

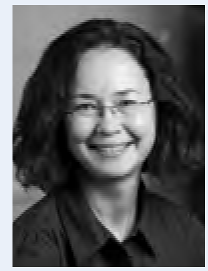
The Ross School is a perfect setting. It is named after Miami Dolphins Owner Stephen Ross, and the sponsors are the International Franchise Association (IFA) and the National Football League.

The IFA is anxious to leverage the star power and the capital that the NFL players can bring to franchising. For the NFL, the program is one of several it offers to assist its players as they prepare for their post-playing careers.

Headlining the four-day program will be former Baltimore Colts receiver and current Carolina Panthers Owner Jerry Richardson, who spent more than three decades as a restaurant franchisee.

Richardson became a Hardee's franchisee in 1961 and grew his business to more than 600 Hardee's restaurants and 200 Quincy Steak Houses before selling the business and becoming president and CEO for the new ownership and managing more than 2,500 restaurants and 100,000 employees.

Internationally known for her work in franchising, U of M Professor Francine Lafontaine will lead the boot camp faculty. She wrote "The Economics of Franchising," which is currently being translated into Chinese.



FRANCINE LAFONTAINE

Her research is focused on the application of advances in contract theory and models of vertical relationships to the analysis of franchising arrangements and other contracting relationships, with an emphasis on incentive issues and firm performance.

We are excited to offer this comprehensive franchising education for our players, said Troy Vincent of the NFL. This program builds on the success of our prior initiatives in education, all designed to provide hands-on experiences.

Healthy businesses listen to their customers and anticipate their needs.

There is a business axiom that works for organizations of all sizes from Fortune 500 companies to start-ups and franchises – stay true to the needs of your customers.

Looking at Entrepreneur Magazine's "Franchise 500" list indicates that today's most competitive franchises go after a specific demographic and they know what the members of that demographic are looking for in terms of services and products. In other words, they offer solutions to needs.

TODAY'S MOST COMPETITIVE FRANCHISES GO AFTER A SPECIFIC DEMOGRAPHIC AND THEY KNOW WHAT THE MEMBERS OF THEIR DEMOGRAPHIC ARE LOOKING FOR

The Latino community, which has more than doubled since 1990, is one of those demographics. Another demographic is proud parents who, despite cutting down on their spending, still find money to offer enrichment opportunities for their children. At the other end of the spectrum are seniors. Senior care as a franchise category didn't exist 20 years ago and now has 22 franchises on the top 500 list.

In the franchise business, however, there is another customer – the franchisee. And the franchisor needs to focus on the needs of its franchisees. Basically a franchisee wants a good return on his/her investment. Therefore, it is important that both franchisor and franchisee understand the metrics of their industry whether it is food, tax preparation, or tutoring.

For instance, if they are in the food industry they can expect a three- to five-year return on investment. Anything higher or lower is not sustainable. The cost for opening a unit should be one and a half times the gross sales of an average unit.

It's important that the franchisee know the metrics of their industry, so that they and their franchisor can agree on expectations. The franchisor must also foresee management issues and share best practices with its franchisees.

The franchisee/franchisor relationship is complex. The franchisee has an entrepreneurial spirit that needs to be respected. A successful franchisor understands that and must find a way of providing solutions to every possible pressure point while allowing their franchisees to feel as if they have final control over their destiny.

BOTH FRANCHISOR AND FRANCHISEE MUST UNDERSTAND THE METRICS OF THEIR INDUSTRY

ANOTHER VOICE

TRANSPARENCY ALLOWS FRANCHISEES TO SHARE BEST PRACTICES

MELANIE BERGERON

Melanie Bergeron is an officer of the International Franchise Association (IFA) and chairs the board of Two Men and a Truck, a franchisor with 210 franchisees in the United States.

We've noticed in your presentations, you talk a lot about disclosure; why is it so important to you?

"At Two Men and Truck, we believe in total transparency," answers Bergeron. "That is why we put so much emphasis on the quality of our FDD (franchise disclosure document) and even include Item 19 (earnings claims)."

"We also realize our success depends heavily on the success of our franchisees and we use data to help them succeed. All of our franchisees are on the same system, so we can share monthly sales and expense figures."

"My mother who started the business was a systems analyst and she was first to do this. It's easier now," Bergeron continues. "Sharing the monthly spreadsheet is a great way of communicating accurate information."

It also offers an honesty filter. "Sometimes the loudest person is the one who seems most impressive. But when you look at the figures that isn't always true," she describes.

Data can also shatter the glass ceiling. "When a franchisee feels like they can't grow any more they can look at a neighbor and find opportunity," Bergeron continues.

"Plus it has a mentoring aspect. You can look at another franchisee and see that his vendor costs are a lot less than yours or his sales are a lot higher than yours," Bergeron adds. "Then just call him up and ask how he does it. Some franchisors will provide the data, but they don't connect it to a unit. We think it is important to do that. The only thing we don't share are salaries."

Bergeron also thinks transparency brings peace to the system. When it comes to awarding incentives like trips there is no controversy. It is easy to declare a winner.

Any advice for business owners besides the importance of disclosure?

"Hire a CFO or at least a part-time CFO. In the long run it will save you money," she answers.

Also be serious about succession planning. "It is important to have a succession plan. Have an exit strategy and save so you can have the lifestyle you want in your retirement," she concludes.

Healthcare reform brings a **"play or pay" mandate** for employers and employees.

YOU CAN CONSIDER ALL ALTERNATIVES, BUT ONE. DON'T IGNORE THE COMING "PLAY OR PAY" MANDATES

Beginning on Jan. 1, 2014, employers with more than 50 full-time and full-time equivalent employees will be required to provide at least one affordable group health plan with minimum essential health benefits. Employers satisfy the affordability requirement if they offer a plan option in which the employee contribution level for self-only coverage does not exceed 9.5 percent of the employee's household income.

Employers that fail to meet these requirements will be subject to the lesser of the following non-deductible penalties:

- $2,000 per year per full-time employee (excluding the first 30 full-time employees)
- $3,000 per year per full-time employee who opts out of an employer-sponsored insurance (ESI) and receives subsidized coverage through a healthcare exchange

What is a healthcare exchange? It is a marketplace where consumers can go to shop for health insurance coverage that meets the requirements of the Affordable Care Act (ACA). Exchanges are intended to provide a safety net to ensure access to health care and are important because the ACA has an individual mandate. All individuals must have health insurance coverage or pay a penalty.

For 2014, the individual penalty would be $285 for a family of three or 1 percent of taxable income, whichever is greater; in 2015, it is $975 or 2 percent of taxable income; and in 2016 it is $2,085 or 2.5 percent of taxable income. After 2016 the penalty is adjusted annually for the cost of living.

Each state will have an exchange available to its residents. An exchange can be state run, a state-federal partnership, or federally run. As of the end of January 2013, half of the states had opted for federally run exchanges.

Employers have a lot to consider before the end of the year when it comes to health care. Finding a trusted advisor who can guide you through a comprehensive evaluation of your options is an essential first step.

A review of your current staff size and composition and their average salaries, while keeping in mind plans for expansion, will provide a basis to determine whether you are covered by the new rules and a base from which to analyze your potential exposure to penalties and your cost to comply with ACA's coverage requirements.

It is important to remember that "play or pay" mandates will be based on your staffing patterns this year. In other words, your employee count for 2014 will be calculated on your number of full-time staff and full-time equivalent employees working more than 120 business days in 2013.

After determining your staffing requirements, crunch the numbers and compare the economic and human resource impacts of your options.

One solution may be to reduce your number of full-time employees (employees who work 30 hours or more per week). While this would reduce your exposure to penalties, what would it do to your ability to attract and retain qualified employees? Costs associated with decreased operational efficiency can quickly exceed the cost to offer affordable coverage to your employees. You can consider all alternatives, but one. You can't ignore the coming "play or pay" mandates.

It is important for employers to realize that when the ACA requirements begin in 2014, the marketplace for healthcare insurance is going to change. Some companies may drop health insurance coverage, others will offer unaffordable coverage and face potential penalties, while others will design and offer plans to minimize or avoid penalty exposure. The right solution will vary for each company. Employers have to be prepared to adapt or be willing to pay a penalty for their inaction.

WELLNESS WILL BE A BIG FACTOR IN HEALTH CARE MOVING FORWARD

The current conversation on healthcare reform seems to emphasize expanding coverage and cost reductions. When taking a broader view of the legislation, however, wellness becomes an important part of the strategic plan.

The idea is to help people avoid the need for acute care by living healthier lives. Recent court decisions clarifying the Americans with Disabilities Act pave the way for employers to:

- Develop and enforce policies that prohibit smokers from employment
- Encourage employees to manage their weight through company-sponsored weight management programs or pass on a larger portion of healthcare costs to overweight/obese employees

DEE EDINGTON

Dr. Dee Edington, a noted health management researcher, says wellness is becoming a business strategy like quality and safety, and others agree. Edington recently left the University of Michigan to fully devote his time to consulting on wellness and promoting his cloud-based software that correlates an organization's health strategy with measurable outcomes.

Many agree with Edington's emphasis on measuring outcomes. Most wellness experts indicate that a successful program tracks more than just registration, but measures sustained engagement and progress toward healthy behaviors.

Some companies use teams to leverage peer pressure in achieving wellness goals. According to an MIT study, social reinforcement creates 166 percent better outcomes. What are some of the outcomes an employer can measure? You periodically can ask questions like:

- Do you smoke?
- Do you exercise three times a week or more?
- Do you have a healthy body mass index (BMI)?
- Do you eat enough fruits and vegetables?
- How many nights a week do you get eight hours of sleep?

Record the data and share it. Progress itself is a great reward. Edington questions whether incentives really motivate behavioral change, but some researchers claim competition is fun and four out of five people will participate when incentives are offered. In a recent survey by the research department of Business Insurance, 85 percent of participating public companies said they offered incentives.

As the United States works toward becoming a healthy nation, there will be much discussion, many opinions, and innovative solutions.

Adam Bosworth, formerly of Google Health, has started Keas, a website that employees can use in the workplace. They get points and badges for completing tasks and supporting their co-workers in achieving their goals. Keas uses social networking and game mechanics to build healthy behaviors.

A bank doesn't have to be in your future, **look for alternatives to traditional financing.**

According to the small business Lending Matrix and Analysis prepared by FRANdata for the International Franchise Association early last year, franchisees could only raise 80 percent of the money they were looking for to grow their businesses.

Factors contributing to the shortfall, included:

- Tighter credit standards
- Greater risk aversion by banks because of increased scrutiny by regulators
- Tax uncertainty
- A depressed housing market that still hadn't bottomed out

Perhaps the depressed housing market is the biggest factor. Historically the franchise finance market has been driven by home-equity lines of credit, and those are harder to get because of the current financial climate. But there is money available. And even when the housing market picks up, you might want to investigate your alternatives.

It is generally accepted that your first step should be a bank. Banks will be looking for 20-30 percent equity as well as verification of the source of your down payment. Remember they favor brand name franchisors with long track records, so it is not just you, but the franchisor they will look at.

ABOUT 10 PERCENT OF SMALL BUSINESS LOANS GO TO FRANCHISES

With this in mind when you are selecting a franchise you might want to consult the Coleman Franchise Report. It has a compilation of SBA-published statistics on franchise performance since 2001.

Just like they favor brand names, banks favor borrowers with whom they had previous experience or who are figures in the community.

If you don't fit that profile you could consider a Small Business Loan. About 10 percent of SBA loans go to franchises. The loans usually range from $250,000 to $500,000, but can go up to $2 million. If you are a veteran you may be able to leverage the Patriot Express program that makes loans of up to $500,000 to active-duty military, (preparing to transition to civilian life) their spouses, or survivors.

Boefly.com, an online matchmaking site that pairs borrowers with lenders could be another option. As of November 2012, Boefly had more than 2,400 active lenders ready to make small business loans.

Crowd funding can't be forgotten in the mix. It is unclear if crowd sourcing would completely fund a project, but according to Boefly, "entrepreneurs with equity from crowd sourcing could be very attractive to their pool of lenders. It will substantially enhance their equity ratios, one of the key financial ratios that lenders look at in their underwriting process."

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