Analysing the future of Franchising in New Zealand for the New Millennium

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Abstract

Although relatively young, franchising offers strong performance and growth projections in New Zealand. Franchising in New Zealand can be estimated to account for $6.5B annual turnover from a conservative estimate of 200 systems. The number of people working within franchising is estimated to be 45,000 in 5,000 franchised and company-owned units. The number of systems, outlets, and those employed in them exhibit steady increase although, following the recent downturn in the economy, the turnover is no longer exhibiting the spectacular 25% increase of a few years ago. Some respondents experienced significant difficulties in their expansion activities. The third annual survey of franchising in New Zealand was conducted in conjunction with a similar study in Australia. The results are collated from 90 Franchise Systems who responded to the questionnaire in New Zealand and 165 in Australia. Trends that emerge from this study suggest that the demographics of the sector will change in a number of important aspects as the industry matures. Industry groupings will move from predominantly retail to a service basis. While the size of the individual systems will grow, the limited market size will favour overseas expansion. There appears to be a trend for some entrepreneurs to manage a series or group of franchises, some through creating additional franchises and others by buying or merging with existing franchises. The move from permanent staff to a predominance of part-time and casual workers will impact the employment mix. At the same time systems are tending to convert from company-owned to franchised units. Business format franchises fundamentally comprises the following elements: the entire business concept which includes the brand and all intellectual property; a process of induction and training in all aspects of the business according to the business concept that is written up in the business manual(s); a continuing process of assistance monitoring and guidance. Franchise systems are likely to be the corporate structures of the future. As such they represent an opportunity for management scientists and operations researchers to be involved in setting up the business format's operating procedures and fine tuning them in response to business and market changes.

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1 Introduction

1.1 Marketing Operations Research

In an article reprinted in a recent ORSNZ newsletter [8] it was stated that operations researchers needed to learn to market their services. Franchising is one growth area in the economy where this may be feasible. This paper examines the current status of franchising in New Zealand, surmises where the industry might be heading and asks the question as to the potential role of operations research.

1.2 The Surveys

The National Bank of New Zealand and the Franchise Association of New Zealand Inc. commissioned Auckland Uniservices Limited to co-ordinate, analyse and publish the results of the (third) annual survey of franchising in New Zealand. Various industry estimates indicate that there are 200 or more Franchise systems currently active. The aim of these surveys is to examine the status of the franchise sector of the economy and to identify trends that will affect the future of franchising. In particular this survey focuses on qualitative factors influencing the direction of franchising in New Zealand and makes a comparison with a similar survey in Australia. In order to maximise response rate, a pre-notification letter was sent prior to the survey. A follow-up letter and phone calls were made to non-respondents. As an added incentive all respondents were eligible for a draw of two Ansett Mystery Weekend prizes donated by National Bank. These were drawn at the Franchise Conference. The survey forms were sent out to a mailing list of over 400 businesses. A Business Format Franchise [4] fundamentally comprises the following elements: The entire business concept which includes the brand and all intellectual property; A process of induction and training in all aspects of the business according to the business concept that is written up in the business manual(s); A continuing process of assistance monitoring and guidance. This excludes Trademarks, Product Relationships and Associated Licenses.

2 Survey Findings

The number of responses received each year varied from 120 (1997), 80 (1998) and 90 (1999). All responses were useable and were analysed although not all answered every question. Where comparisons are made with Australia the 1999 survey (165 useable responses) is compared [2] unless otherwise stated.

For the purposes of making industry estimates (e.g. of turnover, employment and number of franchise units) the figure of 200 systems is used for New Zealand. This figure is based on the number of forms received plus the number of franchise systems that were confirmed to be in business based on follow-up phone calls to non-respondents. Industry commentators believe this estimate to be a very conservative one. The second problem with the survey is that of non-response bias. That is, are the systems that respond, representative of the total population. As there is no independent method of assessing the 'industry' in New Zealand, this cannot be determined. However there was no discernible difference between the responses of those who replied to the initial questionnaire when compared to the (late) responders to the follow-up letter and phone calls.

2.1 Franchisors

Analysis of franchisors into industry type, using the ANZSIC coding system, reveals that most systems are Retail non-food and Personal and Other Services (21% each), followed by Retail Food (13%) and Construction and Trade Services (13% each) and Property and Business services (7%), and Cultural and Recreation Services (6%). This trend away from predominance in Retail (both food and non-food) is a sign of the increasing maturity of franchising within this country. However, as illustrated in Figure 1, there is still room for further expansion into Property and Business Services in particular – for instance, this represents 28% of Australian franchise systems.

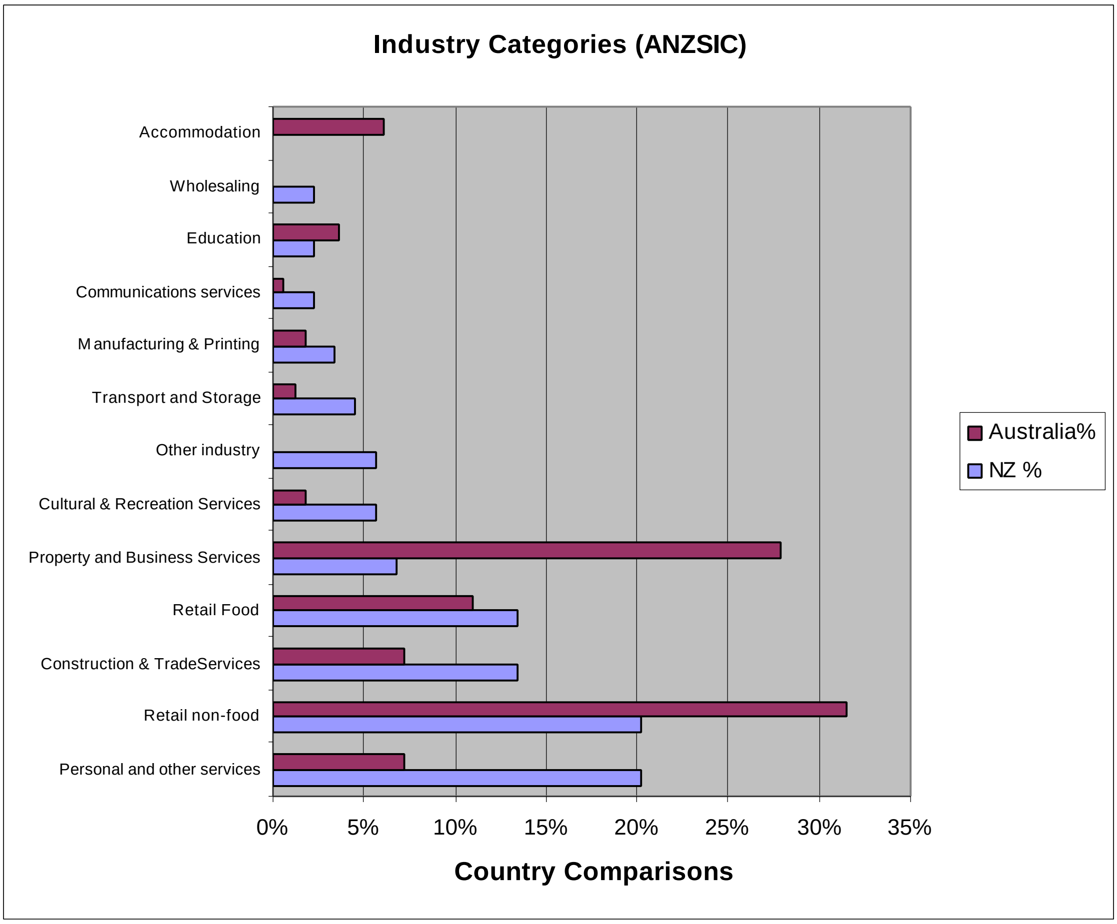

Figure 1: ANZSIC comparisons

2.2 Franchise System Goals and Growth

The growth of franchised units for respondents over the past two years was steady. The average number of franchised units per respondent grew from 22 in 1998 to 24 in 1999 (in the 1997 survey the figure was 20 units). This represents a growth rate of 9%. The median[1] figure was 11 in New Zealand and 22 in Australia (an increase from 20 in 1998). The number of company-owned outlets remained the same in Australia (median 1) but in contrast in New Zealand they dropped (average 10 to 9, median 0).

The respondents were asked for the total system turnover for each of the last two years (with the current one being estimated). This was to be given separately for

[1] Unless otherwise stated the figures refer to the median value in order to avoid distortion due to very large values.

franchised and company-owned outlets. The median figure was three times higher for franchised as opposed to company-owned outlets (reflecting the lower numbers of company outlets) - $2M opposed to $750 000 for the current year. It is noted that this represents a drop from the previous year ($800 000 for the company-owned units while the figure remained the same for those franchised). Of the 67 outlets who reported their turnover (some declined to do so for confidentiality reasons), the total turnover for franchised units was $1,707 million for this financial year and $1,766 for the previous (57 systems). For the company owned units the corresponding figures were $468 million (35 systems) and $283 million (25 systems) giving totals of $2,175 million and $2,050 for the last two years. These figures represented a 1998/99 turnover of $162 500 per franchised unit (up from $152 200 in 97/98) and $450 000 per company-owned unit (down from $495 000).

A similar pattern was observed in Australia (reported in $A) with drops in median unit turnover from $250 000 (1998) to $235 000 (1999) for franchised units and $375 000 to $277 000 for company-owned. In contrast with New Zealand, Australian company-owned units tend to have higher turnover than franchised units but their tendency to have lower profitability in New Zealand has resulted in most instances in a drop in company units.

In regard to expansion planning, only 8% of franchisors did not provide information on a goal for total units in New Zealand. Fewer specified a goal for company-owned outlets. The median figures were for 28 franchised units and 1-2 company-owned units. The apparently low expectations for unit growth are a reflection on the size of New Zealand's population – a similar pattern was observed in Australia. Most (91%) expected to achieve their goal by 2005, as too was the case in Australia (87%). This is likely to be a contributing factor in the trend towards franchising internationally. Of the 75% of systems that are indigenous to New Zealand, 30% are either franchising internationally or expect to do so shortly. The ongoing entry of new franchisors should ensure continuation of growth beyond 2005. The actual growth in the past year showed strong activity in Auckland, the Upper North Island and Christchurch. 37% of the growth was achieved in Auckland where currently 28% of all units are located.

There appears to be a developing trend for some entrepreneurs to manage a series or group of franchises, some through creating additional franchises and others by buying or merging with existing franchises. Most (16%) New Zealand franchisors did not intend to sell, 12% intended to buy, 10% to merge and 31% to create new ones. This trend towards acquisition (53%) rather than disposal was more pronounced than in Australia where 21% intended to sell (although some of these had plans to buy or create another.

Some 53% of respondents experienced significant difficulties in their expansion activities. The most prevalent hindrances cited were '*hesitancy in market/downturn in market*' (24), followed by '*lack of suitable franchisee applicants/difficulty in obtaining franchisee finance*' (20). Others included: '*cost of growth/lack of finance to aid expansion*' (9) and '*negative public perception of franchising*' (5). Unlike Australia, no one listed *the (voluntary) code* as a hindrance to growth. 'Other hindrances' seemed to be Competition, Government legislation, and lack of suitable premises.

2.3 Geographic Distribution

As expected, the majority (69 of 90) of systems had Auckland-based franchisees. They comprised the largest number of units as well (552 of the 1989 sites specified in New

Zealand) as seen in Figure 2. This was followed by Upper (367) and Lower North Island (320) -excluding the main centres - and Christchurch (240). It is not clear why Wellington (210), the second most populous region in the country was again in this survey found to be under-represented in the way of franchise units. A similar pattern was shown in company-owned units with Auckland again having the most (80 of 170), followed again by the Upper North Island (27). However Wellington (19) and the Lower North Island (15) this time had more company-owned units than Christchurch (13).

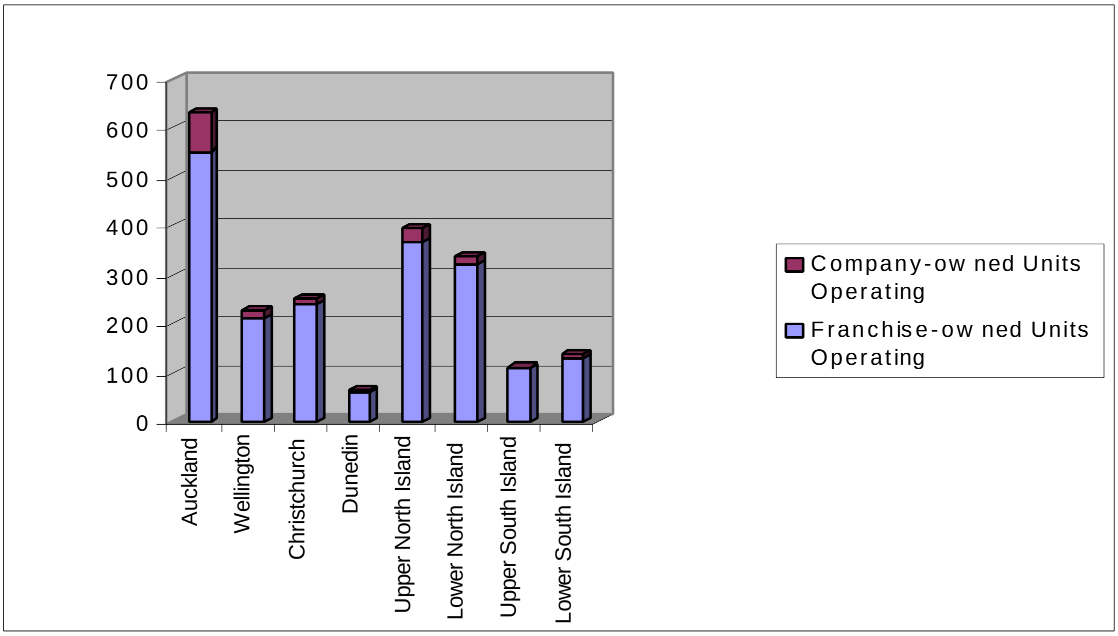

Figure 2 Geographical Distribution.

In the 1997 survey [5] it was found that the majority (62%) of Franchisors were based in Auckland. The respondents indicated the location of 2306 outlets with most (92) franchisors indicating that they had Franchisees located in Auckland (560). Franchisors and Franchisees were located throughout the remaining metropolitan and provincial areas of New Zealand.

2.4 Fees and Royalties

While the total value and breakdown of fees varied considerably both between and within industry sectors, the median total start up cost for a Franchisee was $138,500, compared to the previous year's figure of $113,000 [6]. However, this is most likely to be due to the mix of respondents rather than any real change in costs. One constant was the requirement for working capital to be 13-14% of the total cost.

Most (65%) on-going royalties are calculated on the basis of a Percentage of Sales (average 6%) usually paid monthly (58%) or weekly (26%). Fees based on product mark-up and purchases are typically 25% and 5% respectively. 11% of systems surveyed charge a flat fee. Other methods included charging per unit, charging a percentage of bankings, using a mixture, and by contract. 7% of franchise systems did not involve an ongoing royalty. The typical National and Territory Marketing or Advertising fees are set at 2-3% each. Other fees may include management/accounting and computer fees.

2.5 Employment

The (69) survey respondents employed 15,518 people. These represented 10,725 permanent staff, 3,148 part-time workers and 1,442 casuals. The majority (10,928) was employed in franchised units, with 4,185 being employed in company-owned units and 08 in the 'Head Office'.

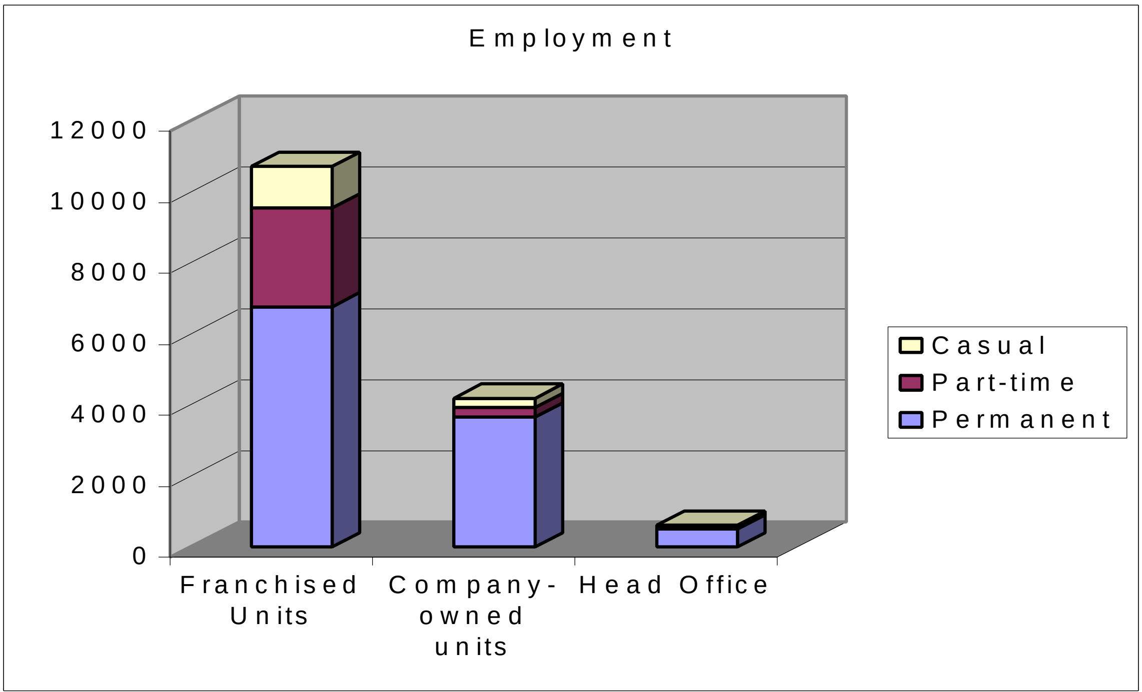

Figure 3 Employment

In contrast the trend in Australian business to rely on casual and part-time staff was evident in their franchising sector. Both franchised and company units employed a greater proportion of casual or part-time staff than full-time staff.

2.6 Disputes

27% of respondent franchisors have been involved in a substantial dispute. However given the total number of franchise units the level of disputes was low (3%). There were 41 disputes instigated by the franchisor and 22 by the franchisees. In each case it was more likely to involve correspondence through a solicitor (54% franchisor-initiated, 68% franchisee- initiated) rather than litigation (29% franchisors, 18% franchisees) or mediation (7% franchisors, 5% franchisees). The main causes of the dispute were likely to be 'fees' (14), 'adherence to system' (13), misinterpretation (11), followed by 'profitability' or communication issues (6 each).

Sale to another franchisee (34 systems, 179 units) was the most common (66%) reason for units 'leaving' followed by termination by franchisor (16, 27 units), mutual agreement (12, 28 units) and termination by franchisee (10, 21 units). The present status of these outlets is most likely to be franchisee-operated (213) rather than company-operated (23) or independent (19). In all 273 units had a status change in the last three years. The median figures for approvals of renewals and re-sales were 98% (18 respondents) and 47% (35 respondents) respectively. The percentage of potential franchises that are approved is 45% (79 respondents) although this varied widely across systems (range 1% to 100%).

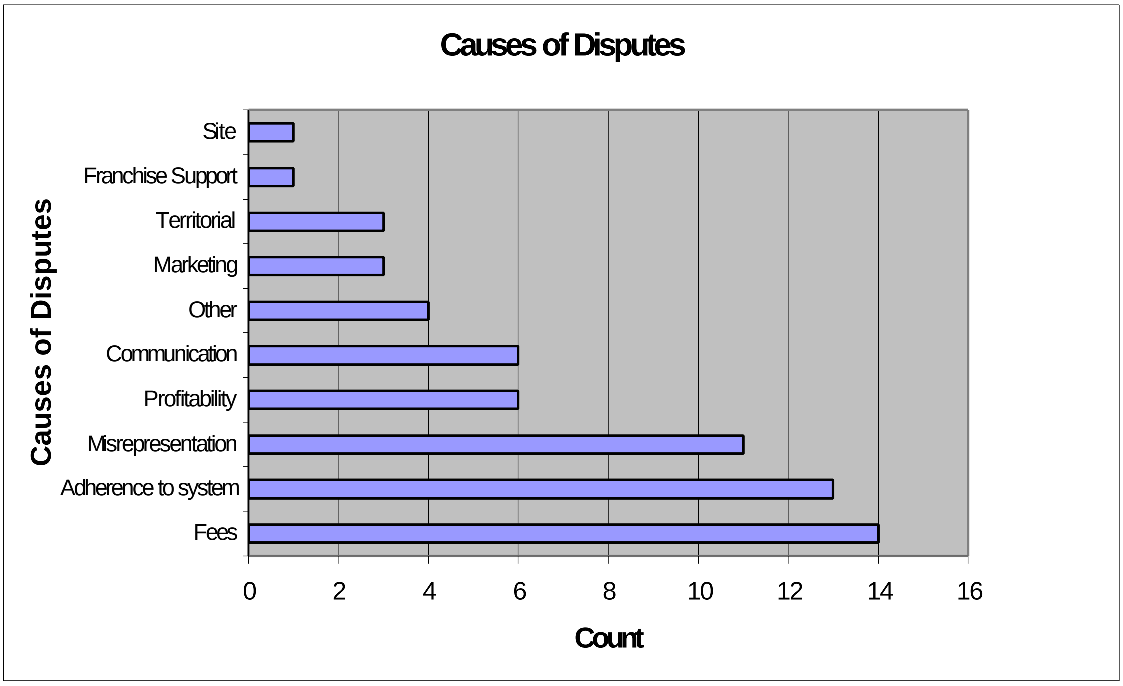

Figure 4 Causes of Disputes

3 Franchise Support Systems

Previous surveys reported on the various support systems available to franchisors. In the 1998 survey [6] it was found that most franchisors provided initial training pre-opening (83%) and on start-up (73%). On average, pre-opening training took 18 days and was followed by 14 days on-site. A turnkey operation which allowed the franchisee to walk into a fully-fitted ready-to-trade unit was offered by 45% of franchisors, and almost all (92%) provided the franchisee with substantial reading matter in the form of manuals averaging a massive 425 pages over three volumes.

Support Type	Frequency	Percentage
Accounting services	34	39%
Advertising/Promotion	72	83%
Banking	12	14%
Credit Control	17	20%
Central Bookings Phone Number	28	32%
Group Buying	62	71%
Human Resources	29	33%
Internet	34	39%
National Advertising Fund	57	66%
On-sale franchises (resales)	41	47%
Point-Of-Sale	39	45%
Telephone Hot Line Service	37	43%
Other (industrial relations, legal, etc)	11	13%

Table 1: Franchise Support Systems

External support to franchisors and franchisees is available through a variety of sources. These Franchise Support Providers include banks, accountant, lawyers as well as specialised companies that deal solely with franchising.

4 The Role of Operations Research

The three surveys did not look at the operation's aspects of any of the franchise systems. However it is obvious that there are opportunities here for MS/OR practitioners. That there is scope for their involvement can be seen from the magnitude of the 'business-format' nature of franchising. For a hefty Royalty fee you are effectively buying into a proven formula (albeit one that requires constant monitoring). The first survey [5] indicted that 91% of systems provided manuals - on average 3 each, totaling 422 pages.

Much of the research into the methods behind these could be the domain of OR analysts etc in areas such as inventory, distribution, product mix, scheduling and capacity planning. Most franchise systems involve high turnover where getting these and other factors correct is necessary to the survival of the business (especially as they pay not only the initial fee but a range of fees based on, for example, turnover). One role of company-owned outlets to act as benchmarks for the system.

The best source of information about Franchise Service Providers (FSPs) in New Zealand is the Franchise New Zealand magazine. The most recent issue [1] was examined to categorise the numbers of these FSPs and the MS/OR expertise that they might provide (Table 2).

FSP	Service	Number	Operations
Accountants	Accounting	13	-
Banks	Finance	4	-
Lawyers	Legal	19	-
Consultants (19)	Insurance	2	-
	Finance	1	-
	Education	1	-
	Human Relations	3	-
	Shopfit/Retail/Expo	4	-
	Sales	1	-
	Technology (web)	2	-
	Operations	5	5?
Total		**55**	**5?**

Table 2: Franchise Service Providers

With this in mind the next stage of this research involved interviewing franchise consultants about their role in setting up and monitoring systems. It was hoped that this would provide further examples of the use of OR/MS targeted to say specific industries within franchising such as Courier, Fast Food, Retailing. Unfortunately, even though the firms involved had people with OR experience on their staff, little or no OR was done.

In Wilson's article [8] several features and benefits of OR were illustrated. The applicability of these to the different industries (based on the ANZSIC codes, Figure 1) or stages of the franchise system's development can be determined. Table 3 has been modified to examine the appropriateness of these (and other) features to franchising.

Feature	Benefit	ANZSIC classifications
Inventory Modeling	Lower investment in stock	Retail, Wholesaler
Decision Analysis	Risk Reduction	All
Optimisation techniques	Reduced operating costs	All
Maintenance planning	Less downtime	Various
Simulation	Improved strategic DM	Franchise Fee Structures
Financial modeling	Greater profitability	All
Data envelopment analysis	Improved efficiency	All
Training Services	Greater employability	All
Personnel Scheduling	Improved efficiency	Retail
Routing Techniques	Lower transportation costs	Transport
Game Theory	Optimal siting of outlets	Most

Table 3: Features and Benefits of OR as applied to Franchise Systems

Inventory modeling can be used by most retail franchise systems, as well as by those involved in wholesaling, manufacturing and possibly by those involved in construction and trade services. Decision analysis can potentially help all franchise systems as can optimisation techniques, simulation and financial modeling. Maintenance planning is required by some organisations providing property services as well as those in the transportation. In particular it can be seen that such features as simulation and decision analysis have a role to play in determining the market share and profitability of different fee structures, especially in the 26% of systems that allow multiple franchise formats. Capacity planning activities are useful here too. For instance they can be used to determine the best configuration to use in retail food outlets such as takeaways and bakeries as well as other 'manufacturing' systems such as printers.

Decision analysis too may be useful in risk reduction as a technique to avoid or mitigate costly and damaging disputes. Although most franchises employ staff (or at least the franchisee needs to be trained) some are involved in education. The need for personnel scheduling will increase in importance, particularly rostering to take into account the forecasted use of part-time and casual employees. Routing techniques appear only applicable to transport organisations (strangely most are owner-operators rather than franchises) but may be applicable to the 27% that are mobile/home based (e.g. those providing personal and other services). In some systems the exclusivity of territories may be important and, even when overlap is allowed, optimal siting decisions may be made using game theory.

5 Summary

The paper does highlight a need for franchise system owners to consider a strategy - for existing systems and a need to think internationally for expansion. In considering acquisitions by mergers, ‘trading-up’ or creating new systems they should consider say a move away from retailing to business and personal services where there is a greater capacity for growth. Although there are many franchise advisors only a relatively small number may be considered to be in the position to provide support in the realm of operations research. From an analysis of the range and volume of documentation involved in setting up franchise systems it is clear that there is a potential for operations researchers to be involved in this process and in the on-going monitoring of the systems. When analysing the range of features and benefits that may apply to different industries involved in franchising, this potential may be realised.

Acknowledgements

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