



IFA's 45th Annual International Franchise Convention
March 6-9, 2005 ▪ WESTIN DIPLOMAT RESORT & SPA ▪ HOLLYWOOD, FL

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Alternative Growth Strategies: Advantages and Risks

Moderator: Harold Kestenbaum, Counsel, Farrell Fritz, P.C.

Speakers: Peter Brown, Vice President, Obee's Franchise Systems, Inc.

**Madison Jobe, Vice President of Franchise Development,
Stockade Companies, LLC**

Robert Smith, Partner, Wiley Rein & Fielding, LLP



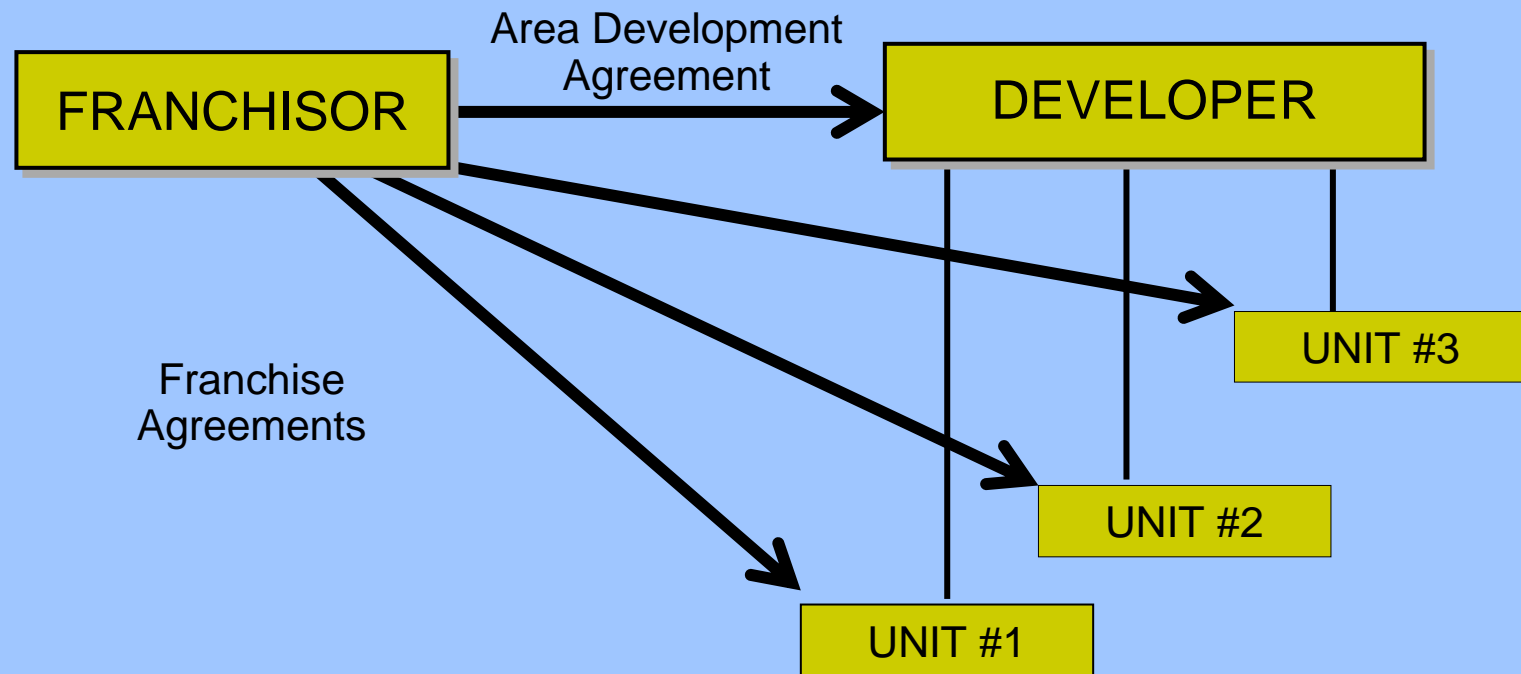
Traditional Forms of System Expansion

- Sale of new outlets to a single unit operator



Traditional Forms of System Expansion

- Area development agreements



Drawbacks of traditional forms may include:

- Slow growth
- Cost
 - recruiting prospective franchisees
 - providing necessary operational support



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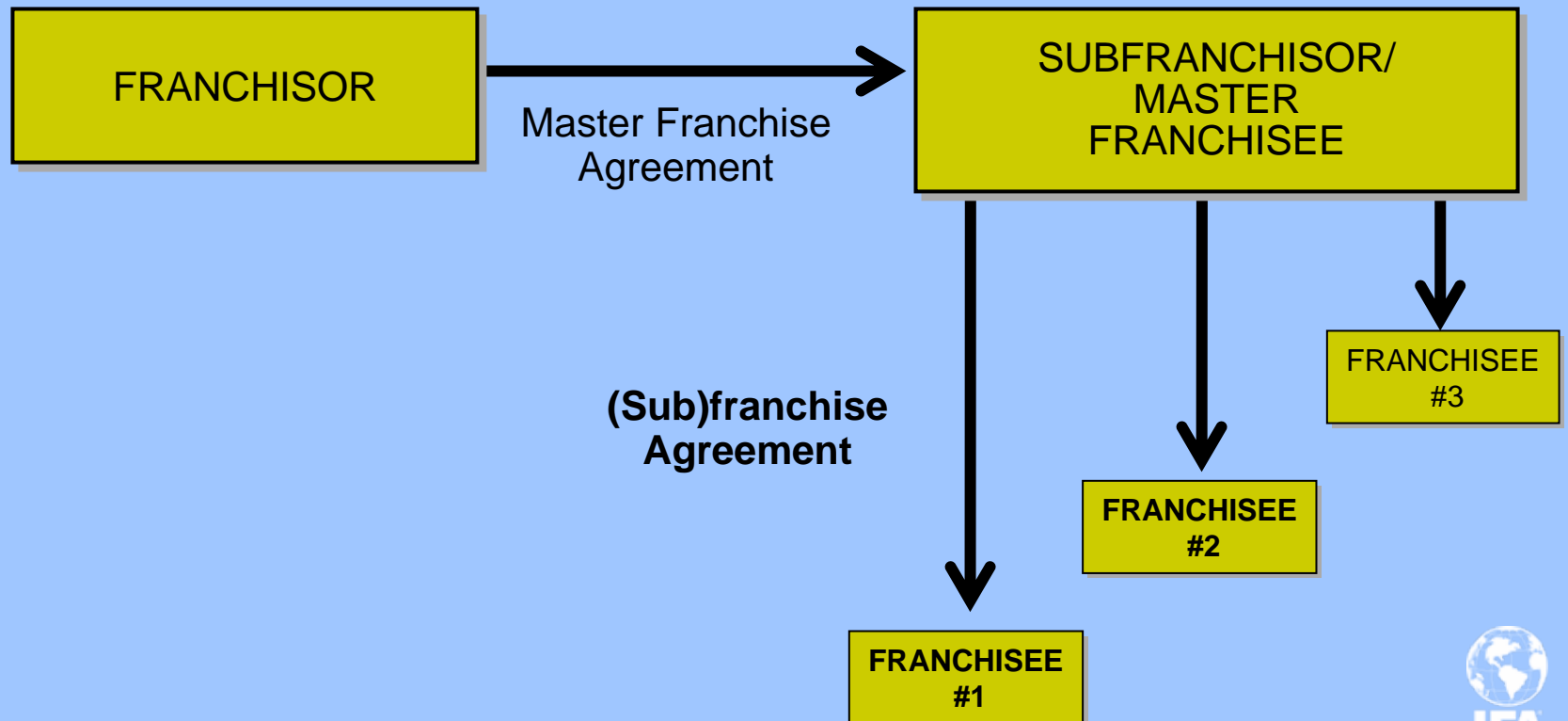
Alternative Growth Strategies

- Master franchising
- Conversion
- Refranchising
- Area representation
- Franchise brokerage
- Joint ventures

Today

- Advantages and disadvantages of each of the alternative growth strategies
- Whether these nontraditional growth strategies are right for your system
- Encourage you to share your experiences with each growth strategy

Master Franchising/Subfranchising



Master Franchising/Subfranchising

2 contractual relationships

- Master franchise agreement – between franchisor and subfranchisor
- Franchise agreement – between subfranchisor and an individual franchisee

Master Franchising/Subfranchising

International vs. Domestic

- Seen more in international context
- Not as prevalent in domestic context
 - coordination of 2 levels of registration and disclosure
 - creation of middle man



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Master Franchising/Subfranchising

Advantages

- Rapid market penetration
- Rapid growth
- Attracts sophisticated investors – more money & business experience



Master Franchising/Subfranchising

Advantages (Con't)

- Ease of market entry especially in remote markets
- Allocation of risk
- Reduction in financial and management resources
- Financial rewards

Master Franchising/Subfranchising

Disadvantages

- Loss of control in operations
- Loss of control in sales process/vicarious liability
- Complexity of federal and state registration and disclosure law

Master Franchising/Subfranchising

Disadvantages (Con't)

- Loss of fees
- Risk of financial loss if termination or failure

Master Franchising/Subfranchising

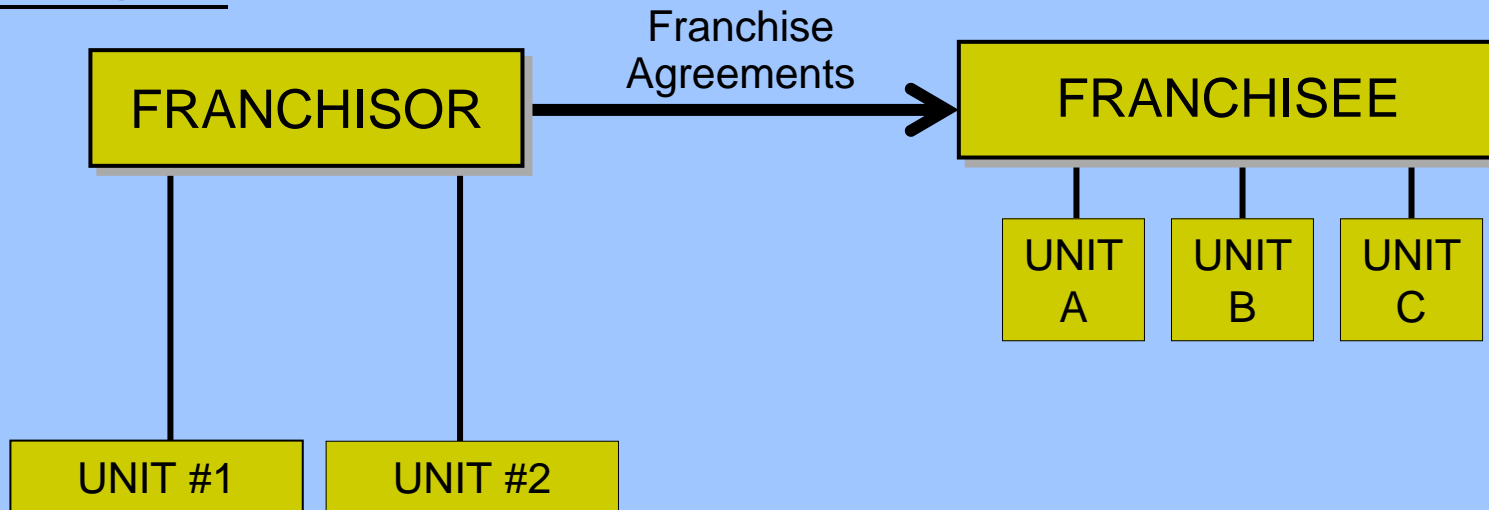
Disclosure/Registration Issues

- Separate offering circulars
 - responsibilities of parties
- Joint and Several liability for failure to provide disclosure
- Disclosure obligations

Refranchising

- Selective sale of company-owned units to members of the franchise community

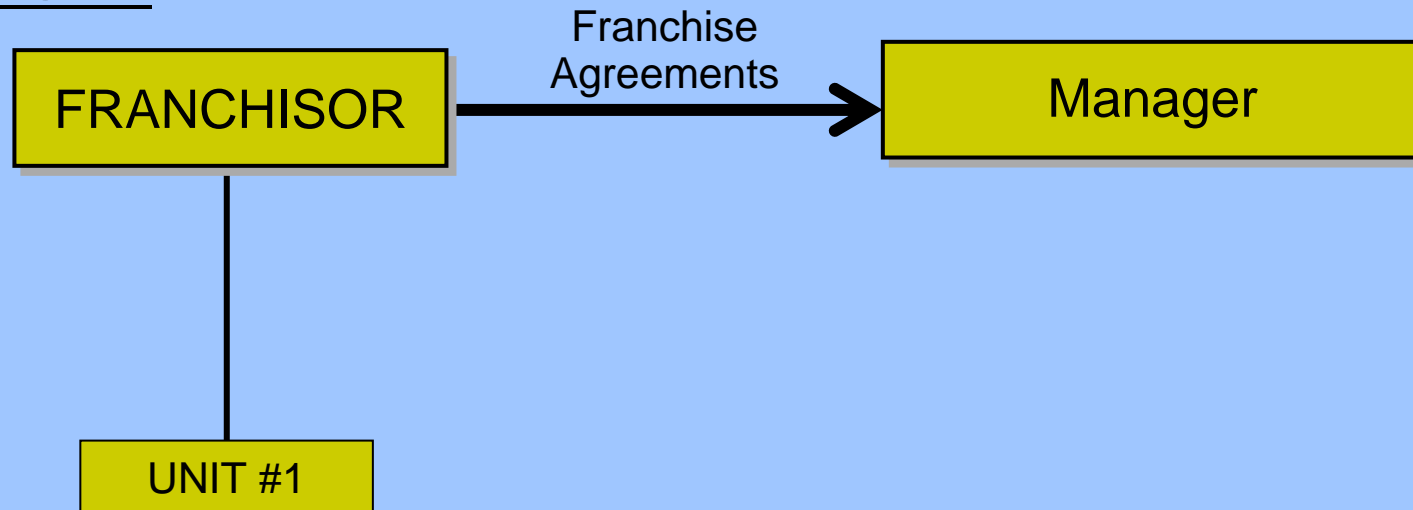
Pre Sale



Refranchising

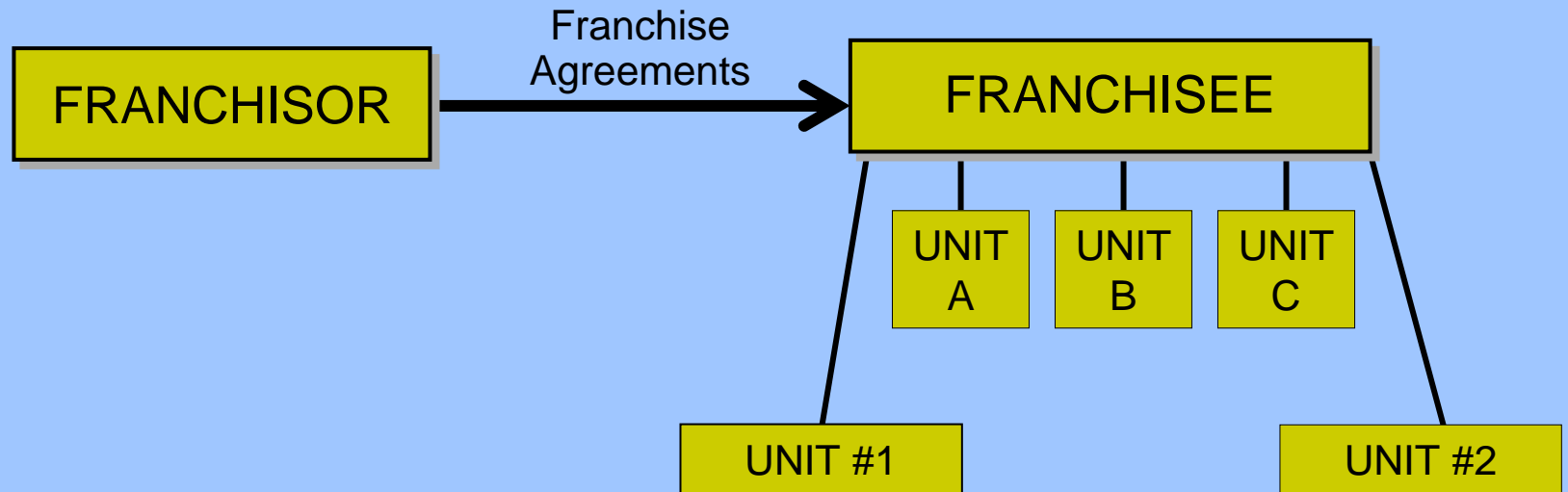
- Selective sale of company-owned units to current management through an Operating Partner Program

Pre Sale



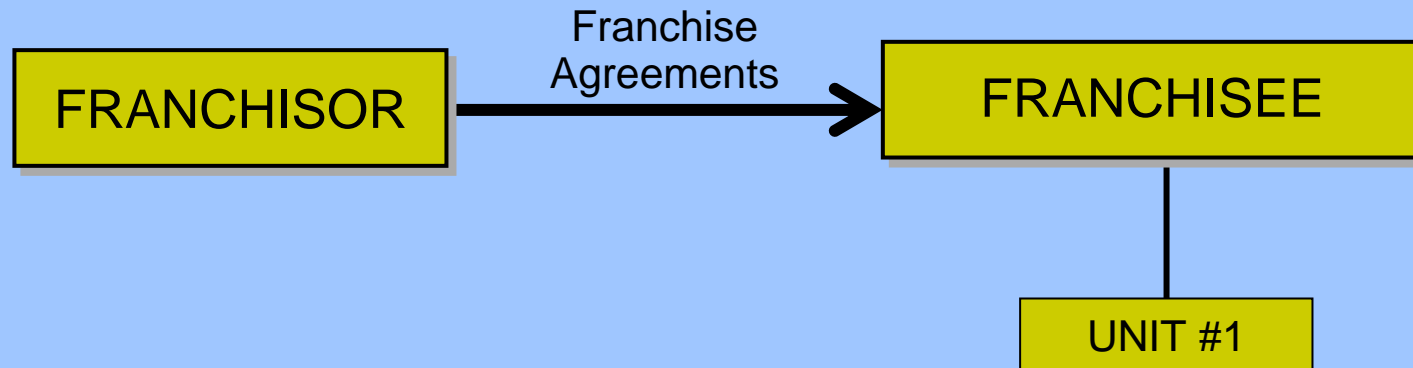
Refranchising

Post Sale



Refranchising

Post Sale



Refranchising

Motivations for Refranchising

- Raise capital/reduce debt
- Improved performance of units
- Exit specific market
- Development of a specific market – company units can be an enticement

Refranchising

Franchisee Advantages

- Instant cash flow
- Compressed ramp-up time
- Possible franchisor financing
- Availability of performance history
- Trained employees and management

Refranchising

How to Find the Right Purchasers

- Existing franchisees who are successful operators
- Operating Partner Program (Manager)
- Multi-unit operators from another concept
- Brokers
- Investment banking firms

Refranchising

Franchisor Advantages

- Retention of control
 - over the franchise system and marks
 - enforcement of operational standards
- No shared fees (as is the case in other growth strategies)

Refranchising

Franchisor Advantages (Con't)

- Drives development of additional units
 - development agreement to develop additional units
 - more units franchisee develops, right to purchase more company units

Refranchising

Franchisor Advantages (Con't)

- Increased capital/debt reduction
- Improved unit performance
- Enhanced brand image
- Decreased number of mixed markets

Refranchising

Disadvantages

- Significant costs (sales process and operational support)
- Overleveraged franchisees could result in costly bailouts

Refranchising

Disadvantages (Con't)

- Personnel and operating issues
- Unhappy existing franchisees who lose power in franchisee community

Conversion

- Conversions of independent businesses, chains and/or franchisees from other systems to franchisor's system



Conversion

Advantages

- Retention of control
- No shared fees
- Elimination of competitors

Conversion

Advantages (Con't)

- Rapid market entry
 - readily available locations
 - time and cost of renovation vs. construction

Conversion

Advantages (Con't)

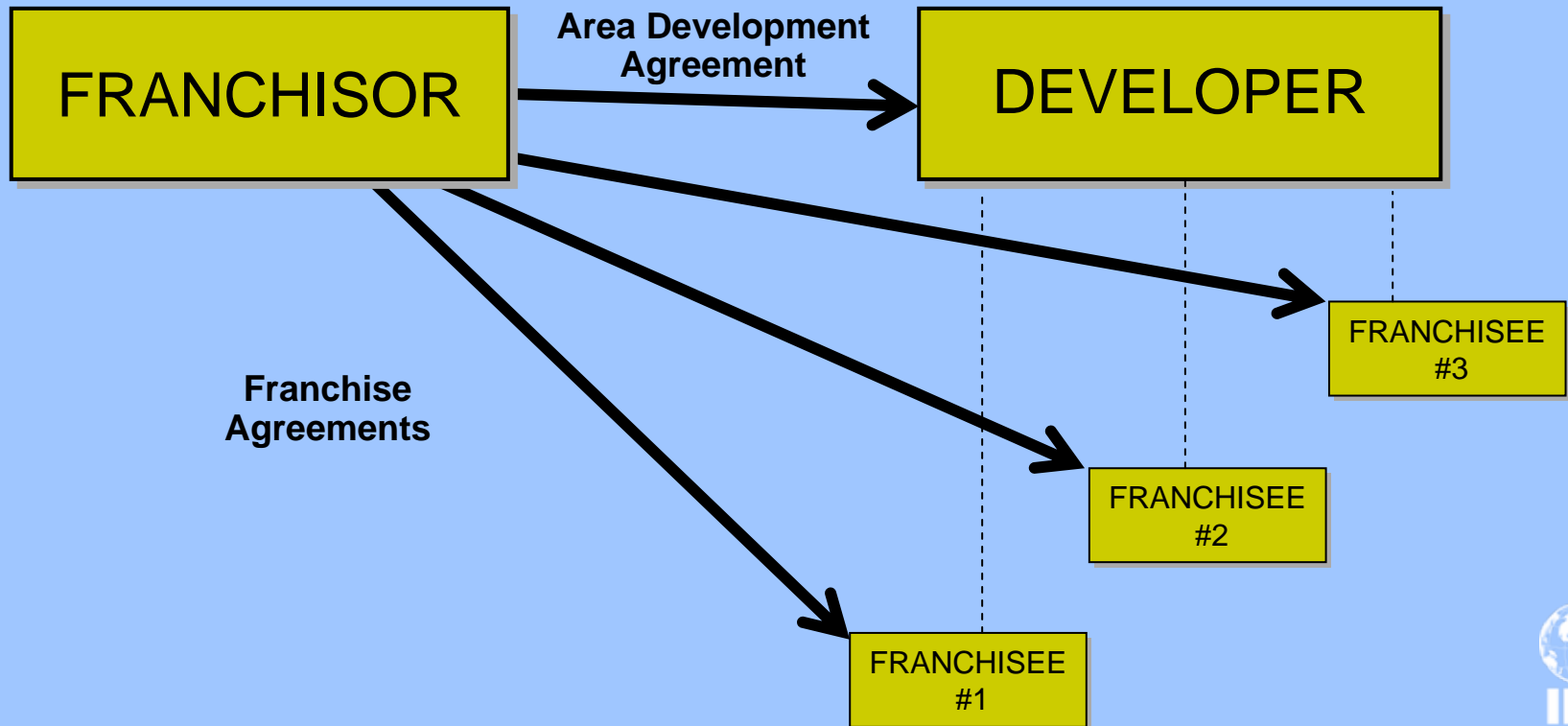
- Addition of experienced operators
 - more limited training and support
 - experience in particular market
 - established customer base and goodwill

Conversion

Disadvantages

- Unhappy franchisees – trouble adjusting to loss of independence
- Costs associated with renovations
- Encroachment
- Costly incentive programs

Area Representation



Area Representation

2 separate agreements

- Area representation agreement – franchisor and area representative
- Franchise agreement – franchisor and franchisee

Area Representation

Responsibilities of Area Representative

- Right to solicit and screen prospective franchisees
- Post-sale operational responsibilities
 - site location assistance
 - training
 - consultations
 - advertising
 - inspections
 - operational assistance



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Area Representation

Fees to Area Representatives

- Portion of initial fee
- Portion of royalty

Area Representation

Advantages

- Retention of control over the franchise system and marks
- Reduced costs
- Local presence
- Efficient response to franchisee's needs

Area Representation

Disadvantages

- Vicarious liability
- Varied skills of representatives
- Replacement of representative
- Dilution of profits
- Expense in negotiating agreement
- Complexity in registration/disclosure

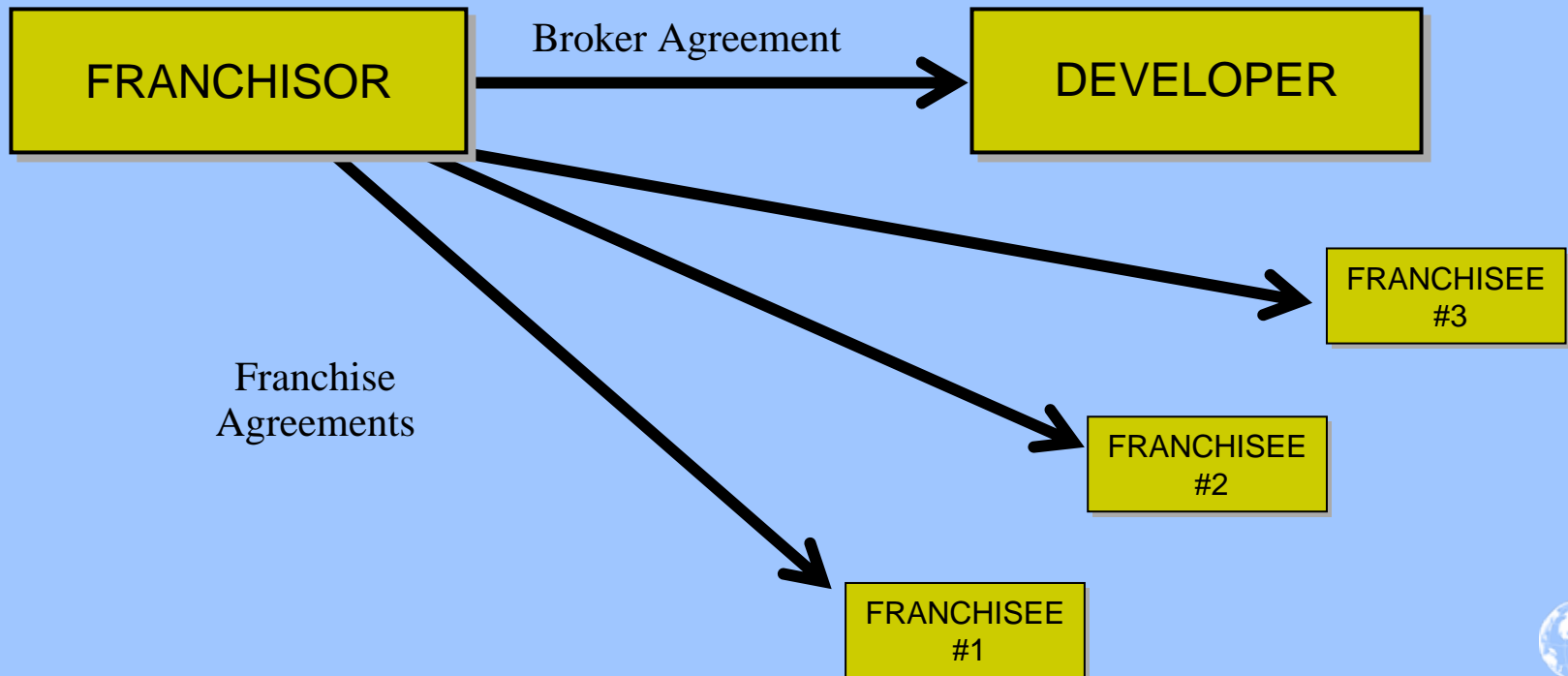


Area Representation

Disclosure/Registration Issues

- Depending on structure, no need for separate registration and disclosure
- Broker registration and disclosure requirements
- Need for disclosure in offering circular of scope of the responsibilities of the area representative

Franchise Brokerage





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Franchise Brokerage

Types of brokers

- Lead generator
- Lead generator plus

Franchise Brokerage

2 separate agreements

- Broker agreement – between franchisor and broker
- Franchise agreement – between franchisor and franchisee



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Franchise Brokerage

Responsibilities of Broker

- Recruiting new franchisees
- No post-sale obligations



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Franchise Brokerage

Payment Structure

- Commission
- Portion of initial fee
- Portion of royalties

Franchise Brokerage

Advantages

- Dedicated to one task - sales
- Experienced sales persons
- Retention of control over the franchise system and marks
- Reduced administrative costs

Franchise Brokerage

Disadvantages

- Lack of incentive to identify top notch prospects
- Vicarious liability
- Expense in negotiating agreement
- Complexity in registration/disclosure

Franchise Brokerage

Disclosure/Registration Issues

- Both franchisor and franchise broker must provide disclosure but disclosure by one will constitute compliance by other
- Joint and several liability for failure to provide disclosure

Franchise Brokerage

Disclosure/Registration Issues (Con't)

- UFOC Guidelines require disclosures in Items 2 & 3
- Proposed changes to FTC Rule would require disclosures in Item 4

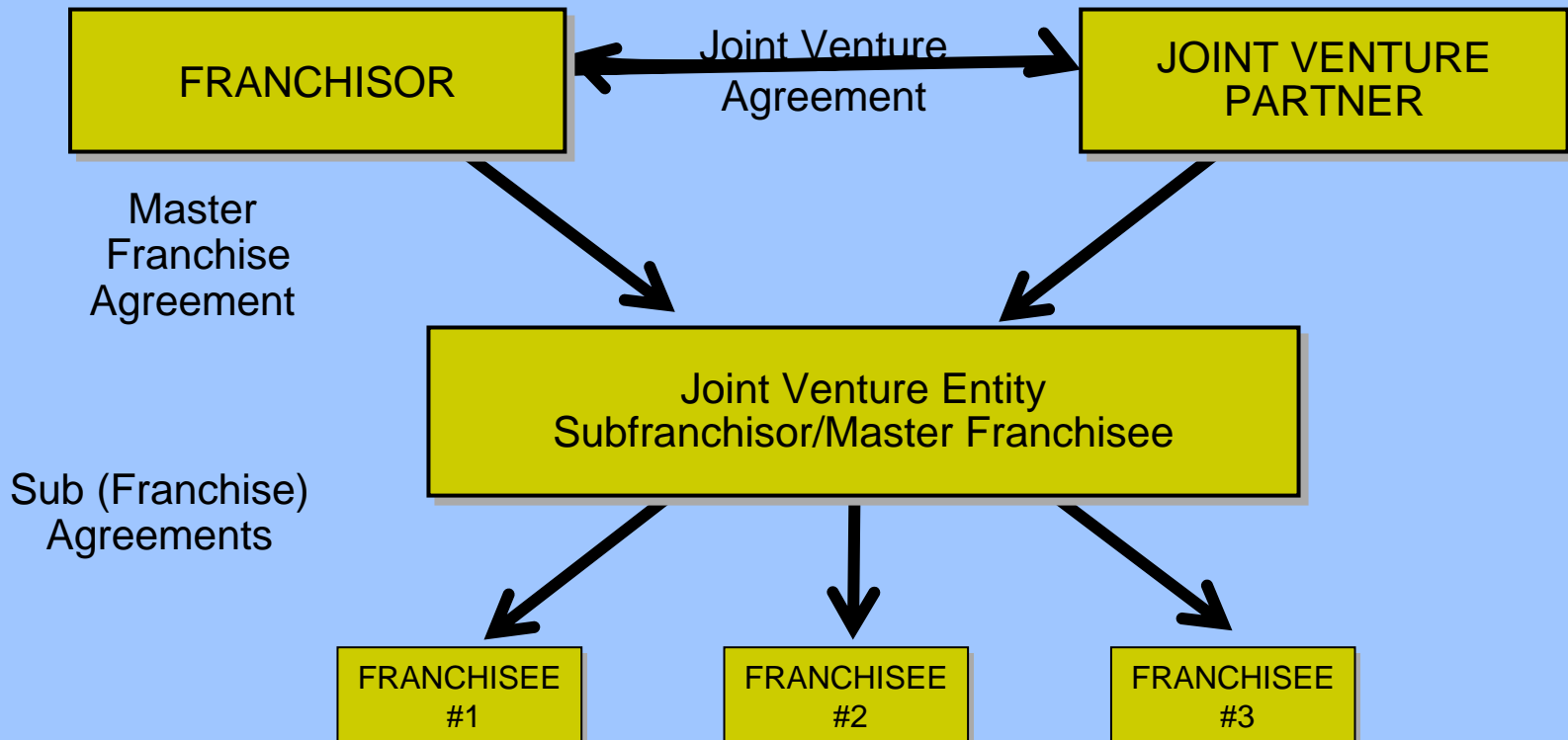
Franchise Brokerage

Disclosure/Registration Issues (Con't)

- Changes may be deemed material requiring an amendment
- State registration
 - IL, NY, WA require registration
 - HI has recordkeeping requirements

Joint Ventures

- Jointly-owned entity with a local partner





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Joint Ventures

Joint Venture Structures

- Corporation
- Partnership
- Limited Liability Company
- Other legal entity

Joint Ventures

Contributions of Parties

- Franchisor
 - license of trademark
 - know how
 - ongoing operational support
- Partner
 - capital
 - human resources
 - management skills
 - real estate

Joint Ventures

New entity typically enters into

- Development agreement or
- Master franchise agreement

Joint Ventures

Advantages

- Rapid development
- Shared risk of failure
- Allocation of costs
- Local market expertise

Joint Ventures

Advantages (Con't)

- More control than master franchising
 - because of franchisor's equity ownership
- More potential for profit
 - because the franchisor holds a direct interest in an entity whose value may appreciate

Joint Ventures

Disadvantages

- Difficulty in negotiating agreements (esp. JVA)
- Difficulty in implementing JVA because of interrelated agreements (JVA, MFA, DA, SA)
- Sharing of profits
 - could be in lieu of a royalty fee
 - financial benefit realized at later date (if at all)



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Are these strategies right
for your system?



Considerations

- Corporate objectives
 - amount of growth
 - location: domestic vs international, specific markets or general growth
 - desire to retain control
 - desire for capital/debt reduction
 - willingness to share fees

Considerations (Con't)

- Market considerations
 - which markets – international vs. domestic
 - desire to expand market or exit from market

Considerations (Con't)

- Market considerations (Con't)
 - interest in mixed market
 - availability of sites
 - receptiveness to concept

Considerations (Con't)

- Economic considerations
 - ability to obtain loans for construction/renovations
 - in economic stress, conversions may work

Considerations (Con't)

- State of development of the franchise
 - maturity may suggest refranchising and conversion are better approaches
 - new system may suggest brokers because no sales force
- Size of sales force

Considerations (Con't)

- Available resources for growth (Con't)
 - how many openings can your support?
 - how many sites can real estate department review?
 - how many trainers on staff?

Considerations (Con't)

- Available resources for growth (Con't)
 - how much operational support for additional units and in far away locations?
 - how much marketing support?

Considerations (Con't)

- Size of system
 - if deep pocket, vicarious liability issues greater concern

Considerations (Con't)

- Creation of liability
 - vicarious liability in sales process
 - not enough support for growth

Dilemma

- If you have systems in place to handle rapid growth, alternative growth strategies may make the least sense