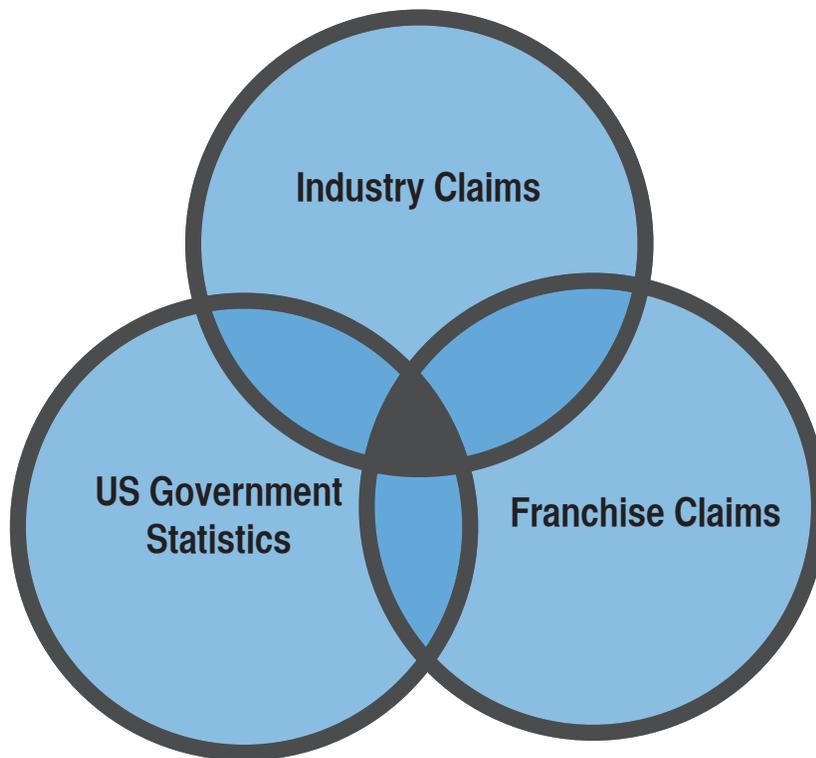


Franchise Success Statistics and Factors:

Are Franchised Businesses More Successful Than
Independent Businesses?

What Information Should Individuals Rely on Before
Buying a Franchise?



A Franchise Study by:

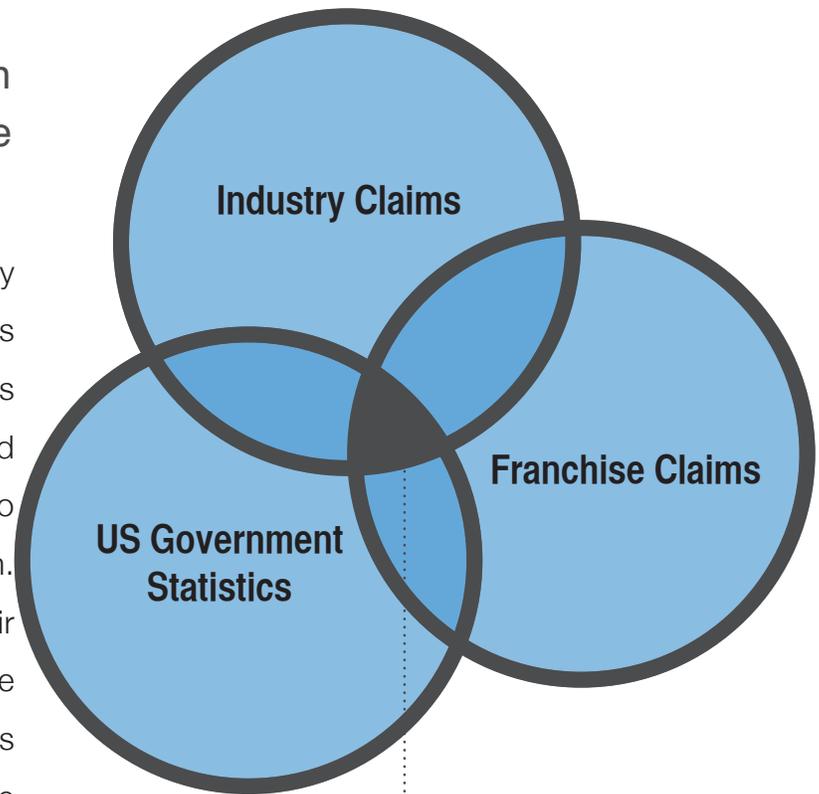
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Are Franchised Businesses More Successful Than Independent Businesses and What Information Should Individuals Rely on Before Buying a Franchise?

Franchising represents an undeniably critical component to the business infrastructure of the United States economy. Franchising is a highly regulated business model that allows businesses to achieve multi-unit geographic expansion. Franchisors license and franchise their existing business model, trademarks, trade dress, supply chain, product offerings and service offerings and package these systems into a business format to be followed by third party franchisees. In turn, franchisees pay an initial franchise fee, on-going royalty obligations and utilize their individual capital toward the establishment of the franchised business. Franchisors provide on-going support and brand protection and franchisees provide managerial and operational support to the operation of the franchised business.



What Matters: “Micro” Business and Economic factors unique to the individual franchisee and franchise investment.

The Franchise Success Question and Success Statistics

In its purest form and for many in day-to-day practice, franchising presents economic advantages to franchisors and franchisees alike. However, franchised businesses, like all businesses - including their non-franchised independently established counterparts - are subject to the business realities of risk and failure. When evaluating the risk associated with franchised businesses, what follows next is the longstanding and evergreen question, debate and claims as to whether or not franchised businesses are more likely to succeed than independently established businesses. That is:

- Is a franchised business more likely to succeed than an independent business; and
- Is a franchise buyer justified in assuming and believing that by purchasing a franchise and becoming a franchisee that he or she is more likely to succeed than if he or she just entered the marketplace by starting an independent business on his or her own.

Important counterparts to the franchise “success question” are “franchise success statistics” related to the claimed overall success rate of franchised businesses. Franchise success statistics, in one form or another, are typically articulated, as follows:

- “Studies show that franchised businesses have a 95% success rate”; and
- Franchised businesses have a [__]% success rate compared to independent businesses which only have a [__]% success rate.

Should Franchise Success Statistics Matter to the Individual Franchise Buyer?

For the individual interested in buying a franchise, issue arises as to the relevance of the franchise success question, whether or not reliable franchise success statistics exist, and whether or not franchise success questions and statistics are relevant or should be disregarded? It is this author's findings that, at the individual level (for someone interested in buying a franchise), focus on the overall franchise success question and franchise success statistics will do more harm than good and, much more often than not, will provide the franchise buyer with a false sense of security in that franchise success statistics are inaccurate, unsettled and, in large measure, irrelevant to an individual franchise buyers investment decision, *i.e.*, generalized industry wide success rates of franchised businesses compared to independent businesses will have no bearing on the ultimate outcome and success of an individuals franchise investment which will be determined by specific "micro" economic, business and legal factors unique to the particular franchise buyer and the franchise system that he or she invests in.

In support of this finding, below we discuss why the franchise success question and success statistics are unreliable, inaccurate and misleading and do so by tracing the origins of the most over quoted and misused franchise success statistic (the "95% franchise success statistic"), evaluating the current state of franchise success statistics (including the position advocated by the Small Business Administration) and, finally, by discussing why the data (no matter what it indicates) should not matter at the level of the individual franchise buyer.

The 95% Franchise Success Statistic and Myth: A Discredited Misinterpretation of a 1980's Survey by the United States Department of Commerce

On May 2, 2005 the President of the International Franchise Association¹ issued a written notice² to its members advising and cautioning them against the use of potentially misleading franchise success statistics. Referring to a commonly misinterpreted United States Department of Commerce Study, in part, the IFA took the following position in its open letter:

It has come to our attention that some IFA-member companies may be providing information about franchising that is long out of date and no longer presents an accurate picture of the sector.

Of particular concern is information claiming that the success rate of franchised establishments is much greater than that of independent small businesses.

Many years ago, the U.S. Department of Commerce conducted studies about franchising which presented such statistics. That information is no longer valid. The agency stopped conducting such studies in 1987.

We strongly urge you to remove any information from your Web site and published materials that make such a claim. The use of such data, in the absence of current research, could mislead prospective franchisees who are attempting to conduct responsible investigations...

¹ The International Franchise Association ("IFA") is a franchise industry membership organization comprised, in large measure, of franchisors, franchise professionals and franchise industry suppliers. The IFA is actively involved in advocacy concerning the franchise industry, franchise legislation and the role of franchising in the United States economy.

² Reference is to the May 2, 2005 open letter titled "A Message from the International Franchise Association President Matthew Shay" from the IFA president to its members. A copy of this letter is annexed to this working paper.

The study referred to in the IFA's open membership letter related to a United States Department of Commerce survey conducted in the 1980's³. Approximately 2,000 franchisors voluntarily responded to the survey (with many other not responding) and within a limited pool of survey respondents the responding franchisors allegedly reported a franchise closure / failure rate of only 5% after five years in business. In interpreting this data, "some within the franchise industry" inverted this data and promoted it as supporting the contention that franchised businesses enjoyed a 95% success rate, i.e., if only 5% failed then 95% were successful. It is widely recognized – including by the International Franchise Association – that the 95% franchise success statistic is an unsubstantiated misinterpretation of the limited Department of Commerce survey and is wrong. The Department of Commerce's survey was not intended to serve as a basis for claimed industry wide franchise success statistics and the survey itself (one involving a limited sample size and a biased population of, presumably, successful franchisors who "voluntarily" responded) was not capable of supporting any claimed franchise success statistics, yet it nevertheless became the source of a pervasive franchise success statistic that continues to influence the beliefs of franchise buyers even today.

Throughout the 1990's franchise success claims and statistics - including the misapplied and erroneous 95% franchise success statistic became pervasive and, at a minimum, led to an overall belief that franchised business are "less risky" than independent businesses and that buying a franchise – almost any franchise – increased an individuals likelihood of achieving business success. Following

³ "Franchising in the Economy 1984-1986" (Washington, D.C., U.S. Department of Commerce, U.S. Government Printing Office, 1986).

the IFA's May 2, 2003 open letter and continuing with a much higher adoption level thereafter, in this author's experience, the vast majority of franchisors and franchise professionals have responsibly avoided or moved away from asserting franchise success statistics, including the 95% statistic and the many variations thereof. However, some⁴ continue to utilize and promote generalized franchise success statistics as a basis for encouraging a prospective franchise buyer to purchase their franchise. Present day examples of the continued use of what this author believes to be either erroneous or potentially misleading franchise success statistics that should be ignored by franchise buyers, include the following claims revealed by a simple internet search conducted by this author:

- 95% Franchise Success Claim by Franchisor in Security Industry – This example is the result of an internet search⁵. The information displayed below relates to use of what this author believes to be the erroneous 95% franchise success statistic. Below is a partial image as it is displayed on the website (the content of which presumably belongs to the alleged copyright owner noted in the footnote) which includes the following statement and claim:

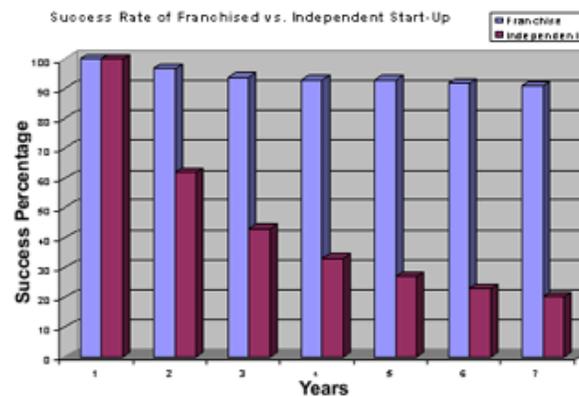
⁴ This author attributes use of the misleading 95% franchise success statistic and variations thereof to "some within the franchise industry". In doing so, this author notes that he has not evaluated the percentage of franchisors and franchise professionals that utilize or have utilized this statistic and that it is this author's experience and belief that those claiming such improper statistics represent a very small minority of franchisors and franchise professionals. The IFA's guidance on this issue has been credible and the vast majority of franchisors, in the author's experience, have avoided such misleading claims and have adhered to the guidance of the IFA.

⁵ Internet search conducted on March 27, 2014. Information obtained and attributed to the following internet domain address <http://www.security101.com/html.aspx?pri=5&sec=24>. The copyright as to the depicted data is claimed "Security 101".

“According to the U.S. Department of Commerce, franchise businesses are exponentially more likely to succeed than individual new start-up’s, particularly if you look at the figures over a five or seven year period. According to Department of Commerce figures, after seven years 91% of new franchises are still in business, as compared to only 20% of individual new start-up businesses.”

Franchise Facts and Statistics

U.S. Department of Commerce Seven Year Study of Franchise vs. Independent Start-Up Success Rate:



According to the U.S. Department of Commerce, franchise businesses are exponentially more likely to succeed than individual new start-ups, particularly if you look at the figures over a five or seven year period. According to Department of Commerce figures, after seven years 91% of new franchises are still in business, as compared to only 20% of individual new start-up businesses.

According to the U.S. Department of Commerce, 95% of franchises are still in business after 5 years. The likelihood a self-launched business will still be in business after 5 years is 47%. Buying a franchise more than doubles your chance to survive as a business owner. And, by picking the right franchise, your chances can improve beyond 95%.
Source: U.S. Dept. of Commerce

What is wrong with this example?

x The 95% Franchise Success Statistic – for the reasons discussed earlier, the claimed 95% franchise success statistic is, in this author’s opinion, not valid and wrong. Use of such information further conflicts with the stated position of the IFA.

x Equating “Success” with “Staying in Business” – The party using this data equates “success” with the fact that “...after seven years 91% of new franchises are still in business...” Even if we were to assume this statistic to be true, for the prospective franchise buyer, it is important to distinguish and understand that just because a franchised location remains “in business” doesn’t necessarily mean that the business is successful. For example the business may have been and remains unprofitable, yet still “remain open”. Further the business may have been transferred and sold by the original owner who was not successful and sold the franchised location.

x The Information is Irrelevant to the Franchise Buyer - If we were to assume this claimed data to be true, this data would nevertheless be irrelevant to the prospective buyer of this franchise opportunity. What will determine success or failure for this potential franchise buyer will not be alleged franchise industry success rates but, rather, the success rates of this particular franchise, the support offered by this particular franchise, the systems developed, maintained and improved by this particular franchise, the experience of the individual franchisee, the capital reserves of the individual franchisee and the working mindset of the individual franchisee. So for the individual franchisee interested in this opportunity any reliance on alleged franchise industry success rates (assuming they are favorable) will provide nothing other than a false sense of security and encourage a prospective franchisee to let his or her guard down.

Quick Facts

→ Just because a franchised location remains “in business” does not necessarily mean that the business is “successful.”

- A Sampling of Other Franchise Success Claims – Based on this author’s preliminary internet search the following quotes demonstrate the continued use of franchise success claims that the author believes to be either wrong or misleading and, at the very least, should be ignored by prospective franchise buyers:

“...Conversely, the U.S. Department of Consumer Affairs reported that less than 5 percent of franchises fail...”⁶

“...According to the United States Department of Commerce, 90% of franchise businesses are still operating after 10 years, while 82% of independent businesses have failed...”⁷

“...According to the Department of Commerce statistics almost 70% of all “independent” businesses fail within the first five years. Franchises have nearly a 95% annual success rate...”⁸

Continued use of the franchise success statistics, as in the past, has and will continue to have the natural and intended effect of causing a prospective franchise buyer to let his or her guard down and to make generalized and erroneous assumptions about the safety of a franchise investment. There remains a false but “bias” among consumers, the general public and, in certain instances, the business media toward the belief that franchises, on a whole, offer less risk for

⁶ Internet search conducted on March 27, 2014. Information obtained and attributed to the following internet domain address <http://www.yogurtini.com/franchise/about-you/why-franchise/>. Copyright claimed by “U-Swirl International, Inc.”.

⁷ Internet search conducted on March 27, 2014. Information obtained and attributed to the following internet domain address <http://www.retrofitness.net/Web/ww/en/whyfranchise.dhtml>. Copyright claimed by “Retro Fitness, LLC”.

⁸ Internet search conducted on March 27, 2014. Information obtained and attributed to the following internet domain address <http://www.candyexpress.com/HTML/usfranchise.html>.

prospective business owners. Individual franchise buyers need to be aware of this potential bias and to understand that although franchising has been and, in this author's opinion, will remain an overwhelmingly positive and productive business model that, at the level of the individual franchise buyer, success and failure will be the product of "micro" economic and business factors unique to that franchisee and the particular franchise system.

The Current State of Franchise Success Statistics and Position Adopted by the Small Business Administration

In the years following the United States Department of Commerce's misinterpreted 1980's survey and the IFA's May 2, 2005 announcement disclaiming utilization of same, to date, there remains no reliable industry-wide studies demonstrating the superior success rate of franchised businesses relative to independently established businesses⁹. Although some data exists, i.e., where certain franchise organizations examine the "success" rate of a limited population of franchisees such "statistics" by definition are limited and not representative of a sample size necessary to support an "industry-

⁹ Although a significant conclusion of this working paper is that industry-wide franchise success statistics are irrelevant to the individual buyer of a franchise, it is nevertheless important for the professional community and business media to understand the current state of franchise success statistics.

¹⁰ For example, FranNet, a national franchise consulting company claims that in an internal survey conducted between 2006 and 2010 that 91.2% of the franchisees they assisted (presumably in buying a franchise) remained in business after two years. This author does not challenge the validity of such survey but issue nevertheless exists as to the propriety of equating a "successful business" with a business "open after two years". A business may remain open and yet not be profitable. From the perspective of the franchise buyer success must be examined based on multiple factors that go beyond the fact that a business remains "open". Information about the FranNet survey may be found at <http://blog.frannet.com/franchise-news/starting-a-franchise-survey-data-show-91-percent-success-rate-for-frannet-aided-franchises.html> Conversely, within the FranNet statistic is the implication that franchise intermediaries can benefit prospective franchisees by educating them, informing them and properly pairing them with a franchise investment and, in turn, increase the franchisees likelihood of success. Although beyond the scope of this working paper, this author believes in the valuable role that franchise brokers, consultants and professionals may serve in increasing a franchisees likelihood of success.

wide franchise success statistic". Moreover many statistics sometimes oversimplify the question of "success" by equating a "successful business" with a business that has "remained in operation for a number of years", i.e., if they haven't closed then they must be successful.¹⁰

In the August-September, 2012 edition of "The Small Business Advocate", a publication of the United States Small Business Administration, the SBA's Office of Advocacy Staff, including staff member Brian Headd, provided some statistical guidance as to the franchise success question. In doing so, the SBA advocated the "survival rate" of franchised businesses were equal to that of independently established businesses. The "FAQ" on this topic was stated by the SBA staff, as follows:

How does franchise survival compare with independent business survival?

Survival among independent businesses and franchises appear to be similar, as they have similar age distributions. Of course each potential business owner debating an independent business or franchise arrangement will have unique factors to weigh, such as their managerial talent and sales abilities.¹¹

Utilizing data from the United States Census Bureau, the SBA Office of Advocacy and Mr. Headd, evaluated the birth (business start-up) and death (business shut-down) ratios

¹¹ In providing their analysis of the franchise verses independent business survival rate the SBA office of advocacy evaluated data from the United States Census Bureau and conducted a comparison of the business "birth and death rates" among franchised and independent businesses. This author reached out to Mr. Headd at the SBA Advocacy Office who kindly identified the source materials that were utilized in this "FAQ" pronouncement. We appreciate the outreach of the SBA and Mr. Headd and their prompt responses to our inquiry.

among independent businesses and franchised businesses. In doing so, the SBA concluded that the birth/death ratios were similar for both franchised and independent businesses and that the survival rate among these businesses appeared similar, i.e., that franchised businesses did not have a higher survival rate. Significantly, in their FAQ response the SBA and Mr. Headd wisely and accurately cautioned and advised that the “franchise success question” – from the perspective of the individual franchise buyer – required an analysis of individual factors or as the SBA stated: “Of course each potential business owner debating an independent business or franchise arrangement will have unique factors to weigh...” The unique factors referred to by the SBA relate to what this author refers to as the “micro” economic and business factors related to the individual franchise buyer and the particular franchise opportunity – not industry statistics.

Quick Facts

→ The best way to determine franchise survival rate may be to evaluate the “micro” economic and business factors opposed to general industry statistics.

What Franchise Buyers Need to Know About Franchise Statistics and Achieving Franchise Success

So where do we stand from a “statistical standpoint”? Well, while the SBA has added accurate, helpful and much needed statistical analysis, *i.e.*, that the survival rates of franchised businesses appear to be similar to and not superior to that of independent businesses, there remains no definitive analysis nor support for reliable franchise success statistics. The SBA’s determination relates to business “survival” rates that, in this authors opinion, does not directly correlate with business success and relies upon an analysis that may be overbroad. For those interested in franchise success statistics – whether as a prospective franchise buyer, a franchisor, franchise professional or the business media - the following points are applicable:

1. Be aware that franchise success claims and statistics –

especially the 95% franchise success claims and its many variations – as the vast majority if not all (absent the findings of the SBA) are either unreliable and erroneous;

2. Be aware that, conversely, there are individuals and organizations that “profit” from attacking and disparaging the franchise industry and, in many instances, they do so with franchise failure statistics (at an industry-wide level) that are equally improper and should be disregarded at the individual investment level, i.e., success and failure rates of the particular franchise that an individual is considering is a relevant factor while any alleged success and failure rate for the entire franchise industry is not a relevant factor for an individual franchise buyer;

3. Assume that franchised businesses and independent businesses, overall, share the same success rates¹²;

4. Understand that for the individual buying a franchise, industry-wide franchise success and failure statistics (including comparisons between franchised businesses and independent businesses) are irrelevant and the factors that will determine the success or failure of a franchised business will overwhelmingly depend on factors unique to you the individual franchise buyer and the particular franchise investment that he or she selects; and

5. For the individual buyer of a franchise, the success or failure of your franchise investment and your franchised business will be determined by “micro” economic and business factors, including:

- Your understanding and awareness that business success is never guaranteed;

¹² This assumption makes sense in light of the insufficient statistical data and the SBA's guidance. For the prospective buyer of a franchise, this assumption should not be viewed as a negative factor. Rather, it should simply serve as a reminder that all businesses whether franchised or independent are subject to risk. This author believes that, on the other end of the franchise success spectrum that there are those that profit from “attacking” the franchise industry and that some of these individuals have, in the author's opinion, misused the SBA's August-September, 2012 FAQ to advocate against franchising. Such advocacy (i.e., don't buy a franchise because an independent business is just as good) misses the mark and completely fails to recognize and understand the dynamics of a successful franchise investment.

- Your business, management and marketing skills;
- Your expectations about your franchise investment and whether or not those expectations are well researched and reasonable (consider that success and failure must be measured against your individual goals and not whether or not your franchised business remains “open” for 2 years or 10 years);
- Your understanding as to the obligations that you will be undertaking once becoming a franchisee, i.e., do you believe that everything will be “turn key” (nothing ever is) and that all you have to do is “turn the key and open the doors” or do you understand that you will be required to continuously work toward the implementation of business and marketing systems to support and expand the franchised business;
- Your available capital and sources of capital to purchase and start-up the franchised business;
- Whether or not you will be financing the establishment of your franchised business and the impact that interest and loans payable will have on the cash flow of your franchise business;
- Your available reserve capital to fund and maintain the franchised business beyond its grand-opening and to sustain the business and your personal expenses during the business start-up phase, i.e., when the business may not produce positive cash flow;
- The particular franchise that you are buying¹³;
- The quality of the franchise brokers, franchise consultants and franchise professionals that you work with;

¹³ It is critical to note that under Federal law and applicable state law franchisors are required to provide franchisees with an extensive franchise disclosure document (the “FDD”). Many factors related to a particular franchise investment, the franchisor, the franchisor’s specific success, the franchisees responsibilities and the franchisees legal rights are disclosed in the 22 separate sections / “items” extensively disclosed and described in the FDD.

- The management team of the franchisor;
- The franchisor's specific success and failure rates;
- The protected territory and other legal rights that may or may not be granted to you;
- Your financial obligations to the franchisor, i.e., recurring royalty obligations;
- The supply chain developed by your franchisor and whether or not such supply chain will serve an economic advantage or disadvantage, i.e., will you obtain products, supplies and services at preferable market rates?;
- The location of your franchised business; and
- Many other factors unique to you and the franchise that you select.

Conclusion

As with life and business – whether franchised or independent – business success is never guaranteed and will always depend on specific factors unique to the individuals and entrepreneurs involved. Those that advocate the sale of a particular franchise opportunity based upon industry-wide statistics premised on a franchise verses independent business success rates, *i.e.*, the claimed 95% success rate and its many variations, offer a narrative that, much more often than not, is false and irrelevant to the individual franchise buyer's decision making process. Franchised businesses will succeed and they will fail. Success is never guaranteed and for the individual franchise buyer, what matters most will be the business and legal factors unique to his or her particular franchise opportunity and investment.

About the Author



Charles N. Internicola is a national franchise lawyer who represents franchisors and franchisees. Mr. Internicola is also a franchisor himself - he is the managing member of a small but national franchise company - and he is the author of *"An Entrepreneurs Guide to Buying a Business or Franchise"*. Mr. Internicola is a strong advocate of the franchising business model and its potential for creating value and growth for franchisors and franchisees alike.

Mr. Internicola believes that franchise success requires information and resources that, much more often than not, is either misunderstood or unknown to prospective franchisees.



Franchisee University is a complimentary resource comprised of franchise videos, books and resources designed to expose prospective franchise buyers to the information and resources needed to properly analyze and evaluate franchise opportunities.

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