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Intro blurb:
Do you have what it takes to be a franchisee? What exactly does franchising entail, anyway? Eugene Honey, partner at Bowman Gilfillan and a member of the Franchising Association of South Africa (FASA's) executive council, sheds light on the industry.

About franchising

What is a franchise?
The Franchise Book of Southern Africa 2006 notes that, according to FASA, "A franchise is a grant by the franchisor to the franchisee, entitling the latter to the use of a complete business package containing all the elements necessary to establish a previously untrained person in the franchised business and enable him or her to run it on an ongoing basis, according to guidelines supplied, efficiently and profitably."

You could compare franchising to a landlord and tenant situation: someone owns a house and lets someone else use it for a fee. In a business setting, the 'landlord' would be the franchisor who owns a brand, copyright, trademarks, know-how and other intellectual property, and lets someone use them in return for reimbursement.

A franchise in its simplest form can be a trade name franchise, where the franchisee pays for the right to use a company's trademark and name – as in the case of many motor vehicle outlets – or a full business format franchise, which includes the use of a range of intellectual property.

It's a unique business model, because although the franchisee owns his or her store, they're merely renting or using the intellectual property.

The success of franchising often stems from the fact that consumers know that they can expect the same product, look and feel and quality of service, no matter which franchise outlet they utilise.

How does a franchise differ from a business opportunity?
Let's take the example of starting your own pizza restaurant, or buying a franchise outlet. When you buy a franchise, your purchase includes the right to use the franchise system's methodologies, systems, recipes, copyright, brand and all other intellectual property. The brand name is hopefully already established and has recognition in the marketplace; and because of that, it has commercial magnetism – it will attract customers. The business model has also hopefully already been refined, and is therefore successful – it's in a developed or advanced state of operations.

If, however, you're starting your own business, you may have to go through the teething problems associated with developing your own systems, recipes, brand and reputation.

Statistics show us that 80% of new franchises are successful, compared to 20% of other new businesses.

At the same time, you must choose the franchise you buy into with care. Factors like location, or appointing the wrong manager can impact on success. Also, if the franchise system is not refined, you will duplicate the original mistakes or inadequacies in your own operation.

How does a licensee/agent system differ from a franchise model?
Essentially, franchising is just a sophisticated form of licensing.

Under a license system, someone owns intellectual property, and allows someone else to use it. Importantly, in a franchise system, the franchisor owns his own business, as does the franchisee – they are two separate entities.

Under an agency system, an agent acts for and on behalf of the principal, as if he is the principal entity.

The two types of contract or structures are similar in that one will find similar types of contractual provisions in each. Both will have provisions such as who will do what, where and how.

What is a master franchise?
Imagine there is a franchisor operating overseas. They're interested in setting up operations in South Africa, but they do not have the infrastructure or wish to establish a business here themselves. They may therefore appoint a master franchisee, a person who will roll out the operation in this country and manage it. The master franchise is an intermediary – although not a franchisor, he performs the same functions, opening stores, managing franchisees and so on.

What is a tandem franchise?
This is where two franchise systems have some sort of symbiotic or complimentary relationship, for example a fast food outlet next to a video hire outlet or a smaller franchisee outlet or kiosk within a larger different franchise outlet.

Research and evaluation
How should one go about evaluating a franchise opportunity?
A Disclosure Document is a key tool in evaluating a franchise and helping a potential franchisee make an informed decision about buying into a specific franchise system. The document should include a feasibility study, exact expenses, start-up costs, the training furnished, employee requirements, and how long it will take for the franchisee to break even.

You should also ask for the names and contact details of other franchisees who will be able to tell you whether for example, the actual performance of the business system meets its projected targets.

What are the advantages and disadvantages involved in investing in a new franchise system?

The advantages are that you might be able to buy the franchise at a relatively cheap price, as the system has not yet had the time to develop in the market a substantial reputation supporting a large goodwill payment which is included in the purchase price. You might also be able to buy franchises in prime locations, before a multitude of outlets have been established in top spots.

The disadvantage is that the franchise system may not yet be proven, so you might experience teething problems as the methodologies are not yet refined, and this impacts on training, recipes and so on. If the franchisors are still learning, you may not receive the full support you require.

It's important to consider these factors; however, remember that some franchise systems are tested extensively before being launched, and can therefore be viable options, from the outset.

What is usual practice when it comes to the franchisor vetting/screening franchisees?

Many franchisors have adopted assessment models from industry consultants such as Franchize Directions and Franchise Plus. These may be compared to sophisticated applications forms which screen out people who are unlikely to be successful as franchisees in that system; just as a company requests a potential employee to undergo a personality assessment.

This is important, because the success of a franchise often depends on the selection of the right type of person as a franchisee. Screening therefore aims to ensure a match between the strengths, skills and attributes of the franchisee and the requirements of the franchise.

Franchisors will look for people who can work alone and are independent self-starters; a crucial factor, because although your franchise is part of a broader network, it operates as your own business. As such, the ability to think as an entrepreneur is a plus. Consider whether your interests are in tune with the business – if you're considering opening a DVD franchise, will you be prepared to chat to people about their choices when they ask for advice? Remember that your franchise will require a lot of input, especially as many franchisors insist that franchisees manage their outlets. Do you have what it takes to deliver on the business' requirements, and are you prepared to put in the effort?

What is a Disclosure Document?

What should a comprehensive Disclosure Document include?

The document should outline the salient features of the franchise, its characteristics, details and a feasibility study.

First, it will list the contact details of the franchisor; the names and details of the shareholders and senior employees of the franchisor, as well as the company's background, history and structure. Next follows a description of services and products, together with the factors influencing success; the details of the franchisor's initial and ongoing support and training; an outline of the contents of the procedural manual; total investment required (including a breakdown of the franchise royalties, administration fees and working capital) and a short feasibility study. Details of other franchisees should be included. Any past and present financial difficulties of the franchisor and franchisee must be noted, along with the full details, requisites, equipment, layout and proposed sites for an average franchise outlet. Finally, the Disclosure Document will include a summary of the Franchise Agreement.

The purpose of the document is to ensure that the potential franchisee has sufficient accurate information to help them assess the franchise operation, and make an informed decision whether to enter the Franchise Agreement or not.

When should I expect to see the Disclosure Document?
As soon as you request it. The Disclosure Document is often used as a selling tool by the franchisor, so they will usually be willing to let you peruse it if they believe you have a real interest in buying into the system.

Will the franchisee have to sign a confidentiality agreement before the Disclosure Document is handed over?
Probably not – although you would be required to sign the Franchise Agreement or a Confidentiality Agreement before you receive additional information. It's not usual practice to sign confidentiality clauses this early because the information contained in a Disclosure Document is often not especially sensitive.

As a prospective franchisee, is it advisable to request access to the franchisor's financial records to assess the stability of the company?
Yes, but the franchisor may decide not to grant such access. That's because you're buying a franchisee outlet, so the information which is relevant to you is the viability, performance and feasibility of that outlet and other outlets, not the financial records of the franchisor company itself. It's like buying a car – you need to know about the car's features, not the features or finances of the company that manufactured it.

The Franchise Agreement

What are the typical terms and conditions of an agreement? What should a comprehensive Franchise Agreement include?
The agreement will first identify and describe the parties (franchisor and franchisee) involved. It will then identify and record the intellectual property rights available to the franchisee through the franchise arrangement, along with definitions of franchised business, intellectual property and so forth.

Next, it will detail the grant of the franchise: whether it is an exclusive, sole or ordinary franchise. Information about payment is also included (including the franchise fee, royalties, advertising, administration fees and working capital).

The Franchisors' Obligations (initial and ongoing) are outlined, as well as the obligations of the franchisee (also initial and ongoing).

Further information contained in the agreement relates to use of trademarks; the operating manual; conditions about change of ownership, death and in capacity of the franchisee and termination; conditions of restraint; disclosure, suretyship, confidentiality, a possible provisional period, as well as general clauses.

Are there particular clauses that prospective franchisees should be mindful of or look to include?
Pay special attention to the grant clause, as this will determine whether you are the sole franchisee operating in a certain territory (exclusive grant); whether the franchisor may also operate an outlet in the same territory (sole grant); or whether there are no restrictions on the number of franchisees who may operate in that area (ordinary grant). The number of operators naturally impacts on your ability to turn a profit.

Make sure you have a thorough understanding of the franchisor's obligations. Bear in mind that although the Franchise Agreement may appear to be onerously biased in favour of the franchisor, it is in the interests of all involved in the franchise system to ensure that there is consistency in branding, service, product and the like. There must be a balance, however, and this is where the franchisor's obligation to develop the franchisee and provide guidance is key.

Do I need a lawyer to look at the agreement? What would they be checking?
It is advisable to ask a lawyer who specialises in franchising – and has experience in this area – to review the Franchise Agreement. They must ensure that there is balance, especially in terms of the franchisor's obligations; that the royalty fees are reasonable; that the business model is commercially viable and that all aspects of the agreement support the success of the franchisee rather than limiting it. This is vital, as an agreement may look simple, but any areas that are not correctly understood may have severe repercussions.

Do agreements have a cooling off period?
The cooling off period is usually 14 days. This is a FASA recommendation, according to FASA's Code of Ethics and guidelines for Best Practice, but it is not legislated.

Franchising fees and ongoing agreements

What does the upfront fee cover?
In a turnkey franchise situation – where the franchisee purchases a complete store – the upfront fee includes fixtures, fittings, equipment, opening stock and the cost of setting up the store. The cost of training is also taken into account, along with the franchisor's management and legal costs and the goodwill element of the brand, which will be more expensive in developed franchise systems.

The upfront fee of an operation which is not a turnkey franchise will cover similar costs, but it may be broken down differently. You may, for example, spend the same on purchasing stock and setting up the store, but this money will be spent with suppliers and possibly not directly with the franchisor.

When and how is the fee usually paid?
It's usually paid into a trust account, or directly to the franchisor on signature of the Franchise Agreement (or shortly thereafter).

What does working capital cover and how much will the franchisee need?
That depends on the business itself. Very few franchises can cover their costs from month one, so you will need sufficient funds to cover – or at least partially cover – the

business' expenses at least until the business breaks even. The feasibility study included in the Disclosure Document is a guide as to how much working capital is required.

What can the franchisee expect to pay in terms of ongoing payment?
The ongoing fees may be termed management service or royalty fees. This is usually calculated around 25% of the business' net profit, or a percentage (usually up to about 6% - 8%) of gross turnover. This monthly fee is for the continued use of intellectual property, as well as administrative and management services provided by the franchisor.

Monies paid for marketing should go into a separate, independent fund which is managed by the franchisor in consultation with the franchisee. This sum is usually about 3% of turnover.

Legal and tax considerations

Is there legislation that governs franchising in South Africa?
The Competition Act makes it unlawful for a franchisor to fix prices for a franchisee's products and services. The Competition Commission also has concerns regarding exclusive suppliers and territories. The latter may however not be prevented if there is vigorous intra-brand competition.

The Consumer Protection Bill is currently in its third draft form, and is due to go to Parliament shortly. The Bill will affect all franchises – current and future – in South Africa. The intention is for the Bill to function as a Consumers' Bill of Rights, and it introduces a substantial number of new considerations in terms of fairness and equity. The Bill will probably enforce full disclosure upfront, and make it possible to cancel an agreement if such disclosure was not offered or if it misrepresents what is sold. That's important, because one of the biggest problems facing franchisees at present is that their purchase of a franchise does not match their expectations, either because a franchisor has puffed up the business system's success, or because they have not known the right questions to ask confirming that success. The Bill will assist in avoiding such pitfalls, by ensuring that fuller relevant information is disclosed upfront.

What is the role of FASA in South Africa?
FASA aims to promote ethical franchising in South African and ensure that international best practice is upheld. The association is a voice for the industry, provides a support and networking function for franchisees, hosts a reference library, and offers a mediation service in settling complaints. FASA further hosts the International Franchise Expo, which matches franchisors with potential franchisees, and the FASA Awards for Excellence. The body, which is now in its 27th year, has done much to advance the development, professionalism and ethics of the franchising industry in South Africa.

What is the criterion for membership for franchisors?
Members must meet and maintain FASA's requirements. They must lodge with FASA a Franchise Agreement that is compliant with the association's ethical code

and best practice guidelines, along with an operations and procedure manual and a Disclosure Document.

How will I, the franchisee, be affected by Capital Gains Tax?
There may be a Capital Gains Tax payable if you sell your franchise.

Will I, the franchisee, be affected by the New Credit Act?
Yes, inasmuch as any other industry is affected. If the franchisor has funded the franchisee, or granted a loan, they will be regulated according to the terms of the Act.

Set up and operations

What should new franchisees expect from the franchisor in terms of an operations manual?
It is not a legal requirement to provide an Operations and Procedure Manual, although it is a FASA requirement. This provides a blueprint for the operation of the franchise.

What should the new franchisee expect from the franchisor in terms of scouting for and securing a location?
This differs between systems. In some cases, the franchisor finds a location, then looks for a franchisee to operate it. On the other hand, the franchisee may approach the franchisor because he believes he has found an optimal location, in which case the franchisor will evaluate it. It’s important that both parties are satisfied that the location is a good one.

What should the new franchisee expect from the franchisor in terms of training and support?
The franchisor should provide adequate and appropriate training, which is sufficient to allow the franchisee to carry on his business effectively and efficiently. Training usually takes place on an initial basis, but may be ongoing as the business requires. This should be outlined in the Disclosure Document.

What should the new franchisee expect from the franchisor in terms of marketing assistance?
This is broad and varied, because it depends on the requirements of the store. For example, if the franchise system is brand new and is not nationally known, it makes sense to advertise locally at first. However, if the franchise is part of an established and national network, less investment in local marketing may be required. The franchisor usually assists with the initial marketing, public relations and a grand opening, but this again depends on the franchise system’s level of development. The franchisor’s obligations are also influenced by the money available in the marketing fund.

Selling your existing franchise

Is there an ‘out’ of the agreement, should the franchisee wish to sell their franchise?
There usually is an out; however, the franchisor must consent to your sale to a new franchisee, so that they can be sure the new franchisee suits the business requirements. It’s advisable to examine your Franchise Agreement to determine

whether there are any restraints, and how long that restriction is. The franchisor may be entitled to a percentage of your sales fee, particularly if further training for the new franchisee is needed.

After what period is a franchisee able to sell their franchise?
This is dictated by the terms of the Franchise Agreement.

How does a franchisee go about selling?
The sale is conducted in conjunction with the franchisor, as their consent must be obtained before the sale goes through. The franchisor may be able to put you in touch with prospective franchisees, or you may advertise as you would with any other business. The franchisor often makes the ultimate decision about whom the franchise is sold to.

Buying an existing franchise (re-sale)

Is there a benefit to buying a re-sale franchise?
Yes; you’re buying a business that is hopefully already established and has ironed out any initial problems. Your staff will have received training, you are likely to have a regular clientele, and the business may also be generating profits. There’s no guesswork as to the viability of the franchise (as when buying a new outlet), because it will have been in operation for some time. Be careful, though, they you don’t overpay for the business – carefully consider the information including financial information provided.

How should one evaluate an existing/re-sale franchise?
Evaluate the outlet using similar information as if you are buying a new one. The difference here is that the outlet would have been trading for some time so having a look at its financial records and speaking to existing staff regarding performance of the outlet and any difficulties experienced will be very useful.