STUDIES OF SMALL BUSINESS FINANCE

Franchising and the Financing of Small Business

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THE INTERAGENCY TASK FORCE ON SMALL BUSINESS FINANCE

Board of Governors of the Federal Reserve System
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Office of the Comptroller of the Currency
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Small Business Administration
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I. Introduction

Franchising in the United States can be traced at least to the beginning of the twentieth century with the development of franchising in automobiles and soft drink bottling. The 1930's saw the creation of franchised distribution systems by petroleum marketers and wholesalers in areas such as pharmaceuticals and hardware. During the 1960's and 1970's franchising moved into new areas, the most visible of which is the fast food restaurant business. This modern movement is important for two reasons: one, it has made franchising a significant and in some cases a dominant way of doing business in sectors that have been traditionally populated by small firms; two, it occurred since enactment of major Small Business Administration (SBA) legislation which was predicated on the idea that small business needs and deserves government assistance in financing.

The purpose of this paper is to address various policy issues occasioned by the growth in franchising. The most important of these is how franchising affects the availability and cost of financing. Another issue raised is how the SBA should regard franchisees and in some cases franchisors in its overall program of providing financial assistance to small business.

Before the policy issues are address, it is necessary to define franchising and identify the participants. Numerous definitions exist, but one that captures the essence of the arrangement was proposed by Caves and Murphy (1976, p. 572).
We define a franchise agreement as one lasting for a definite or indefinite period of time in which the owner (the franchisor) of a protected trademark grants to another person or firm (the franchisee) for some consideration, the right to operate under this trademark for the purpose of producing or distributing a product or service. Its central features are the rental of an intangible proprietary asset and the operation of a decentralized production or distribution process.¹

One would thus expect franchising to prevail in industries in which a trademark (or goodwill) is important and in which the production or distribution process is locally limited and decentralized. As Caves and Murphy (1976, p. 594) state: "Franchising appears to prevail where efficient scales of operation diverge markedly between the production of a good and the production or development of the goodwill asset attached to it."

Although this definition does not specifically mention financing as a rationale for franchising, it is consistent with the hypothesis that franchising arrangements are able to tap sources of financing in combinations that would not be available either to a fully integrated chain or to a fully independent small business. The idea of divergent minimum efficient scales of operation suggests that different types and amounts of financing may be needed at the two levels of the operation. Furthermore, if the financing needs at each level of the operation do not correspond to access to financial markets, one may observe financing

¹ Parenthetical statements added. Other definitions can be found in Brown (1973), Curry (1966) and Kursh (1968) and elsewhere. We chose to use this definition because of its generality and its emphasis on the existence of a trademark or goodwill as a central feature of the arrangement.
flowing between levels within the franchise. This may explain why franchising, which is almost universally regarded as a means of providing capital for an expansion minded franchisor, may also involve financing flowing downstream from the franchisor to the franchisee.

A search of the literature revealed little direct empirical evidence on the impact of franchising on financing costs and availability. However, there is a considerable body of literature making often quite emotional claims about the advantages and disadvantages of franchising for the participants as well as for society. 2

For the franchisee the usual alternatives are an independent (non-franchised) business or a job working for someone else. Advantages and disadvantages are generally expressed relative to operation of an independent business, and include services provided directly by the franchisor to the franchisee, such as training and financial assistance, and benefits derived from affiliation with a larger organization, such as trade-name recognition, greater purchasing power and lower borrowing costs.

In considering prospects for a franchisor or potential franchisor, the alternatives are either a wholly-owned integrated chain of outlets or a system of completely independent dealerships. Also the attractiveness of franchising will depend upon the type of product or service under consideration and upon the stage of the company's life cycle.

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2 For discussion and analysis of advantages and disadvantages, see Vaughn (1979) and Kursh (1968).
Among the advantages allegedly accruing to franchisors are the following. First, franchising is a way to raise capital. To quote Vaughn (1979), "less capital is required by the company that expands through franchising: the franchisees furnish the capital. The franchisor can use his capital for other purposes" (p. 63). Second, the profit incentive causes franchisees to work harder and more efficiently than a manager of a company-owned store. Third, compared to a wholly-owned integrated chain of outlets, franchised stores will enjoy greater flexibility in meeting local market conditions and are more likely to be accepted in the community. Fourth, if the alternative is no expansion, the income from franchise fees, royalties, leases and sale of goods must be considered an advantage.

For society, these advantages should imply greater ease of entry into business, lower failure rates and decreased economic concentration by providing a viable alternative to completely integrated chains. It is also claimed that franchising benefits society by providing opportunities for minorities to own their own businesses and assists consumers in our mobile society by providing standardized products.

There are, of course, purported disadvantages to franchisors, franchisees and society. For franchisors, company-owned stores may be more profitable, provide greater management control (particularly in shifting resources among geographic regions and in trying innovative approaches to business), and encounter fewer legal problems. Also, it is claimed that the cost of capital obtained from the franchisee may be
higher than the cost of alternative sources of capital. This is a claim we address in more detail later in the paper.

Franchisees may find themselves at a disadvantage relative to the franchisor because of their smaller size, lack of market power, legal expertise and business sophistication. As a result, franchise agreements may be one-sided in favor of protecting the prerogatives (and profits) of franchisors. Dissatisfaction will result if profits fall short of expectations and problems may arise upon termination of the franchise contract. In the worst cases, unethical selling techniques and fraudulent franchise schemes may destroy a family's life savings. In addition to those purported undesirable social consequences, franchising is said to be an anticompetitive system of distribution which crowds out or forecloses opportunity by independent small businesses.

Although it is not our purpose to assess the overall desirability of franchising, we do present some evidence later in the paper. In order to make useful policy recommendations on the relationship of franchising to government small business assistance, it is necessary to know something about the relative importance and growth of franchising in the economy.

The 1970's saw two divergent trends in franchising. Dominating the available data, the number of automobile and truck dealers and gasoline service stations declined, while their average sales grew because of structural changes and rapidly increasing prices within their respective
industries. By contrast, franchising in other areas continued to grow; an increasing proportion of the number of retail and service establishments were franchised. Sales per establishment of franchisee-owned units grew much more rapidly than the average of all retail/service establishments while the franchisor-owned units grew much less rapidly. Established franchisors continued to add franchisees to their respective systems and many new franchisors entered the market during this period.

The data suggests that, while the automobile and gasoline industries are moving to their own beat, franchising in other areas has not yet peaked. Excluding automobile and truck dealers and gasoline service stations for the period 1972 to 1977, one of every eight new establishments (net) was franchisee owned.\(^3\) Growth continues in absolute and relative terms and any substantial movement toward consolidation of franchisee-owned establishments into "corporate chains" or franchisor ownership is not evident in the data.

It may be concluded that expanded opportunities for both franchisees and franchisors will continue to exist, and franchising's impact on the financing of small business will increase in importance.

\(^3\) Further evidence on the growth and relative importance of franchising was included in an earlier version of this paper and is available from the authors.
II. Financing Franchises

A franchise arrangement may affect the availability or the cost of financing in a number of ways. To the extent that franchising relative to other organizational forms yields net benefits to the participants, financing terms should be more favorable. More specifically, if business risk is reduced, the cost of capital should be lower. The cost and availability of financing to the franchisee will be influenced by any direct assistance provided by the franchisor. Franchising is also regarded as a means of providing capital for the franchisor and the cost of this capital is relevant to a franchisor considering alternative distribution systems.

In considering these financing aspects, it is well to note that franchising is not an industry, but a method of business organization that may be employed in a number of industries. The financing needs of franchises may be determined primarily by the nature of the industry within which the firm operates. Firms dealing in goods tend to require proportionally more short-term financing for inventories or accounts receivable, while service producing firms require proportionately more long-term financing to acquire the capital equipment necessary to produce the service (e.g., motels, rental cars). In addition, economies of scale in retail and service outlets would certainly vary across industries and influence the level of financing required. Business risk faced by a firm may influence its desired level of financial risk and thus its degree of financial leverage. With this disclaimer, we present
evidence and an analysis of the ways in which franchising can affect the
cost and availability of financing.

Evidence for Advantages and Disadvantages of Franchising

Evidence on general advantages and disadvantages of franchising is
provided in a few empirical studies and in judgments of various writers
on the subject. Empirical studies have generally been surveys of either
franchisors, franchisees, or both. Vaughn (1979) interviewed executives
of 116 fast food franchisor firms and obtained the following results:

- Ninety-two percent of the franchisors reported that they
  charged a continuing royalty fee. Average: 3.0 percent
to 4.8 percent of gross sales.

- Eighty-nine percent of the franchisors charged a franchise
  fee. Average: $5,950-$11,540.

- Seventy-three percent of the franchisors obtained revenues
  from renting or leasing the land or building. Average fee
  not reported.

- Seventy percent of the franchisors obtained revenues from
  an advertising assessment. Average: 1.3 percent to
  2.6 percent of gross sales.

- Sixty percent of the franchisors obtained revenues from
  the sale or lease of equipment. Average fee not reported.

- Forty-seven percent of the franchisors obtained revenues
  from the sale of food products. Average fee not reported.

- Thirty-nine percent of the franchisors obtained revenues
  from the sale of paper products. Average fee not reported.

Vaughn supervised interviews of owners of 224 small retail
businesses in the suburban areas of Boston. The interviews covered
"three franchised types and one independent group, namely: gasoline
station proprietors, automobile dealers, owners of other types of franchises and a matched group of independents."

According to the franchises, franchisor help had extended across the board to the many specific things necessary to starting and operating the business.... However, franchisor assistance was most often provided in the area of product or service promotion, franchisee training and the providing of operations manuals and sales kits....

Despite some complaints about the franchise, an overwhelming percentage (80 percent or more) of the franchisees reported they would buy the franchise again. Reasons for wanting to buy the franchise again were largely the result of excellent income, although the reasons did cover a broad spectrum. Vaughn, (1979, pp. 72-73).

A study by Walker (1971) found that franchisee satisfaction resulted largely from good income and the feeling of independence. Dissatisfaction reported by some respondents resulted from lower than expected returns.

Perhaps the most thorough study of franchising was done by Ozanne and Hunt (1971), research conducted at the University of Wisconsin and sponsored by the Small Business Administration. Their study surveyed franchisors and franchisees in fast foods, convenience grocery and laundry-dry cleaning industries, with the purpose of exploring:

- the economic effects of franchising;
- the characteristics of franchisees;

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4 Earlier studies, though useful as descriptions of franchising, were limited in empirical value because of the small samples employed. Lewis and Hancock, The Franchise System of Distribution (1963) had samples of 50 franchisors and 40 franchisees in eleven areas of business. Curry, et al., Partners for Profit (1966) was based on empirical analysis of responses from 65 firms.
o the characteristics of franchisors;
o the role of minorities in franchising, and
o the nature of the franchisee-franchisor relationship.

The findings of this study are widely quoted and will be referred to again later in this paper. Ozanne and Hunt (1971) concluded with respect to starting a small business:

Applying, franchising does make a significant contribution to the creation of independent business. The 67.9% of present franchisees who were not self-employed in their last prior employment gives a suggestion of the maximum contribution of franchising to the establishment of independent businesses. In response to a question asking what they would be doing if franchising did not exist, 36 percent of the franchisees believed that they would not be self-employed. This figure provides a minimum estimate of franchising's contribution, and the combination of the two figures suggests that, were it not for fast food franchising, somewhere between 13,700 and 25,800 small, independent businesses would not have existed at the end of 1970 (pp. 37-38).

Although they find some negative aspects, specifically that most franchisees (72.5%) earn less than the "minimum expected" and work long hours, that there may be problems with system failures, buybacks and terminations, and that some services provided by franchisors are not highly valued by franchisees, Ozanne and Hunt state:

We conclude that the net economic effects of franchising as a system of distribution are positive. Without franchising, thousands of small businessmen would never have had the opportunity of owning their own business. Similarly, franchising has enabled many entrepreneurs with little capital to take an idea and from it build a large multi-unit organization. Without franchising, these entrepreneurs would have had to give up their idea or
attempt to sell it to some large corporation. Any system which opens up economic opportunities for the "little guy" should be carefully nourished and protected. Franchising represents a viable alternative to large, completely integrated corporate chains (p. 63).

While opposing views can be found in the literature, including horror stories of fraudulent schemes and inept management, we believe that the general conclusions of the Ozanne and Hunt study are reasonable. We do suggest later some mitigating factors that must be kept in mind but conclude that, on balance, the franchising movement has increased the opportunities for small business.

We turn in the next part of this section to an analysis of failure and turnover rates among franchised operations.

A. Failure and Turnover Rates

This sub-section presents estimates of the turnover and failure rates of franchisee-owned establishments. Earlier, Ozanne and Hunt (1971) pointed out the importance of distinguishing between "turnover" (all changes in establishment ownership) and "failure" (ownership change or withdrawal due to real or impending insolvency) and correctly criticized several earlier studies for failing to make this distinction. Both rates impact on the financial aspects of franchisees. Any ownership change, regardless of reason, is the occasion for re-financing while failure rates are a major component of the riskiness of supplying capital to franchisees. Thus, the questions for our purposes are, "How many new franchisees come into existence each year?" and "What are franchisees' chances for failure and how do these chances compare with similar non-franchised businesses?"
In what follows, three points should be kept in mind. First, we are concerned only with the turnover and failure rates of franchisees: conceptually, franchisor-owned establishments are merely the outlets of a corporate chain. Second, the risks and uncertainties which face franchisees are no different than those which face other small retail and service businesses, with one major exception: any franchisee enters and continues in business as a legal and economic "dependent" of the franchisor. So, in addition to the usual sources of turnover (e.g., sale of the establishment to a new owner, failure) there are additional occasions for turnover which may be forced by the franchisor during the life of the franchise agreement or at renewal time. Furthermore, in addition to the particular localized market forces which can produce failure, the franchisee faces the further risk of franchisor failure; while many non-franchised establishments might find the failure of their major supplier to be a severe blow, the franchisee's lack of separate identity means that such a blow will probably be fatal. Third, while the data now available to estimate turnover and failure are somewhat better than those available to the Ozanne and Hunt study (1971), they still leave much to be desired. For one thing, no estimates of either failure or turnover can be made for automobile dealers or gasoline service stations. Between 1972 and 1977, the estimated numbers of franchisees in these two sectors declined by about the same amount as the number of franchisees increased in all other areas. However, the decline was "net" and, presumably, turnover (part of which represented
failure) continued. On a different note, there appears to be some overlap in categories of relevant data collected by the Commerce Department's survey, a point to be discussed below. Finally, once turnover and failure rates are computed, the problem of finding a suitable basis of comparison remains.

**Estimating Turnover**

From the data available to them, Ozanne and Hunt calculated turnover from four sources of ownership change: "(1) franchised outlets ... repurchased by the franchisor for company operation, (2) franchised outlets ... repurchased by the franchisor and then resold to new franchisees, (3) franchised outlets ... sold by franchisees to new franchisees and (4) franchised outlets ... discontinued." With additional data available, we are able to add two other sources: (5) franchisee-owned outlets of franchisors that fail and (6) franchisee-owned outlets terminated by franchisor during the life of the agreement. Item (5) was estimated from data reported by the Commerce Department showing the number of failed franchisors, the total number of franchised outlets and the proportion of sales of such outlets accounted for by franchisee- and franchisor-owned establishments. Since the data are drawn from a survey of franchisors, it is not known if some of the franchisees did, in fact, survive; but the assumption made here is that all went under with their respective parents. Point (6) involves data first collected in 1977. At first glance, it might be thought that "terminations" would be subsumed by "discontinuances" and, indeed, the
total discontinuances of franchisee-owned establishments in 1977 (5,710) exceed the terminations of such outlets for that year (5,074). However, if one examines the data sector-by-sector, there are areas in which terminations exceed discontinuances by very wide margins (e.g., convenience stores and nonfood retailing). All of this suggests that "discontinuance" means that the establishment ceases to exist as part of a franchised system, while "termination" means that the agreement with a particular franchisee was cancelled during its ostensible term.

Table 1 presents the estimate of turnover for 1977. It appears that 16,025 franchisee-owned businesses experienced a change in ownership during 1977. Expressed as a percentage of the total number of franchisee-owned establishments for that year (190,242), the turnover rate for 1977 was 8.4 percent. It should be noted that there was a net increment of 13,441 franchisee establishments during 1977. Thus, the combination of turnover and growth resulted in 29,456 new franchisees entering business during the year.

Before leaving the topic of turnover, a few words need to be said about buybacks and non-renewals. As can be seen in Table 1, there were more units converted from franchisor to franchisee ownership in 1977 than were bought back by franchisors. This net "sell off" by franchisors was also true for 1975 and 1976 and, while there was a net buy-back in earlier years, its magnitude had been steadily declining. Thus, there appears to be a trend away from buying back.
As for non-renewals, these data were first reported in 1977. During that year, 14,122 franchise agreements came up for renewal, 8 percent of all agreements in effect when the year started. Of those up for renewal, 693 (or 4.9%) were not renewed. There were, as expected, substantial differences among various sectors.

**Estimating Failure**

The estimation of failure is more complex. Since failures are a component of turnover, the failure rate cannot exceed 8.4 percent. Components (1), (2) and (3) of turnover appear clearly to be non-failure-related ownership changes. If one wishes to assume that all discontinuances and terminations are, in effect, failures, the total failures for 1977 were 11,944, a failure rate of 6.3 percent. Ozanne and Hunt (1971) assumed that all discontinuances were failures. If discontinuances involve the cessation of operations of the establishment (implying an inability to find a buyer for a "going business"), the assumption is probably valid. On the other hand, "terminations" are a different matter. If a franchisee terminates an existing agreement to "go independent" or to affiliate with another franchisor, clearly no "failure" is involved. From the 1977 Commerce Department data, we know that 2,390 terminations were made by the franchisor and, of those, 931 were for non-payment/financial default. If we accept this 931 as the hard-core failure count of terminations, the minimum failures for 1977 appear to be categories (4), (5) and 931 from (6)—a total of 7,801 and a failure rate of 4.1 percent. Thus, within the limitations of the
available data, we estimate the failure rate for franchisees (excluding auto dealers and gasoline service stations) as falling between 4.1 percent and 6.3 percent. It should be noted that the 1,160 failures attributable to franchisor failure represent 9.2 percent to 14.9 percent of this failure rate.

It is difficult to find data to which this estimate may be compared. Any overall rate is affected by the proportional composition of the aggregate on which it is based and the rate for franchisees, many of which would be relatively "new" and concentrated in such traditional "high risk" sectors as restaurants, might be expected to be higher than that for all retailers.

If one accepts the assumption that all discontinuances are failures, the discontinuance rate for franchisee-owned establishments was proportionately greater than for franchisor-owned establishments in the 1972-77 period. During these years, the discontinuances of franchisee-owned establishments accounted for 86.4 to 91.4 percent of all discontinuances while the proportion of all franchised establishments owned by franchisees ranged from 79.1 to 87.5 percent. Thus, it appears that the failure rate of franchisees is somewhat higher than comparable franchisor-owned establishments. Of course, they may not be completely comparable; over time, franchisors may come to own the more desirable and/or time-proven establishments which are less prone to failure.
B. Financial Assistance Provided by the Franchisor

The franchisor may have access to lower cost capital or to different financing sources and may provide loan guarantees or direct loans to franchisees. Evidence of this is found in the study by Ozanne and Hunt (1971) which presents data on sources of funds for a first franchisee unit (see Table 2). The data indicate that 19.2 percent of franchisees responding received some funds from the franchisor, with 8.7 percent of total funds needed coming from this source. However, the authors indicate that there is little potential for expansion of franchisor assistance beyond this level.

The 8.7 percent is apparently direct assistance in the form of either loans or equity participation. There is no indication of the interest rate charged or of the existence of loan guarantees or cosigning in addition to this figure. It should be reemphasized that these figures are for the fast food industry only.

Data on direct financial assistance are presented in Table 3. It is difficult to generalize on the type of financing provided, and thus the Table simply contains information on whether or not some type of financing assistance is offered by the franchisor. Overall, slightly less than one half of the franchisors provide some type of financial assistance. However, when restaurants are broken out, a different picture emerges. Only 38 of the 180 restaurant franchisors provided any type of financial assistance. We hypothesize that this may be because of the nature of financing needed by restaurants. Restaurants appear to
be largely service producers and have investments in longer term assets such as buildings and equipment rather than inventory and receivables. A maturity matching strategy of financial management would then indicate a need for a relatively larger proportion of long-term financing, either debt or equity. The franchisor may be unwilling or less able to provide this type of financing to the franchisee. Although it is difficult to tell from the data, it appears that franchisors are more likely to provide assistance in obtaining short-term financing.

Financing the Franchisor

Although we have described financial assistance flowing downstream from franchisor to franchisee, it is clear that franchisors contemplating expansion regard franchisees as a source of capital. In commenting on this issue, Vaughn (1979) states:

Senior executives from nine companies (eight well-known franchise companies, plus one other) spoke at the Boston College Franchising Conference on the advantages and disadvantages of franchising, and six of the nine executives pointed to the fact that franchising is a way to secure capital. Hewitt (1956) also pointed to this virtue of franchising in his study of automobile franchising. Less capital is required by the company that expands through franchising: the franchisees furnish the capital. The franchisor can use his capital for other purposes (p. 63).

As a disadvantage, Vaughn (1979) cites this response:

On the financial side, one executive pointed out that the cost of capital secured from franchisees is exorbitant. The franchisee's initial investment, he maintained, should be recovered by him in two or three years. That means a 33 1/3 percent-50 percent return on investment! This is pretty expensive capital for the franchisor. He could probably get the money easier and much cheaper directly from lending sources (p. 65).
While franchising is widely viewed as a method of raising capital for expansion of a distribution system, this is one of few mentions we found of the cost of this type of capital. This statement contrasts dramatically with Caves and Murphy (1976, p. 575) who speculate that there may be advantages to franchising "... because franchisees supply funds at implicit interest rates below the market price." The cost of capital as it is used here is an opportunity cost concept, the rate of return that the franchisor presumably could earn if he owned the outlet unit in question. There are, of course, a number of problems with the specifics of the analysis underlying the Vaughn quotation. First, the 33 1/3 to 50 percent return is not a compound annual return, but an alternative statement to the payback period. Second, in determining whether this is an expensive source of capital, the relevant comparison is not borrowing by the franchisor. The funds provided by the franchisee are probably more like equity capital for the entire system. This may be true even if the franchisee raises his capital in part by borrowing. If this is the case, the relevant comparison is the cost of alternative sources of equity capital, not borrowing by the franchisor. If the financing provided by the franchisee is not regarded as a substitute for equity capital, an argument could be made for using a

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5 If the receipts generating this return stop at the end of the payback period, the internal rate of return will be zero. If these receipts continue at a constant level for all eternity, the stated return, 33 1/3 to 50 percent, will equal the internal rate of return. Thus, these numbers would be the maximum expected internal rate of return to the franchisee and thus the maximum compound annual cost of capital to the franchisor.
weighted average cost of capital, but clearly the cost of borrowing is not the appropriate comparison. Third, it is not clear whether the statement nets out the return to the franchisee's labor, and, as noted before, labor provided can be considerable.

Since the 33 1/3 to 50 percent range seemed high, and since this was based on the opinion of one commentator, we attempted to get some comparison from publicly available data. Since published data are not generally available on individual franchise units and estimates of expected income supplied by franchisors are notoriously optimistic, we imputed a rate of return for a franchise based on the 1978 Form 10-K and other information for McDonald's Corporation and Subsidiaries. The critical assumption in this exercise is that company-owned stores are similar in size and profitability to franchisee-owned operations. Assumed borrowing rates and leverage ratios are also used, and are varied within reasonable ranges to analyze the sensitivity of the results to these assumptions. An investment of $255,000 in plant and equipment is required to obtain a McDonald's franchise. McDonald's now charges new stores a royalty of 11.5 percent of gross sales; the average fee charged in 1978 was 10.42 percent, the figure used in Table 4. The assumed borrowing rate of 12 percent represents a 3 percentage point

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6 The 10-K reports $352,928,000 in royalty fee revenues from 3,573 franchised units. The average fee of 10.42 percent implies sales of the average franchisee are $947,946. This compared to $800,634 reported on average for the company-owned stores. To ensure conservative estimates, we used the latter figures as imputed sales per franchisee unit.
markup over the average prime rate of 9 percent for the year 1978. We have no data on the actual rate charged, and the markup could have been more or less than this; but the 9 percent prime can be used as a benchmark for comparison of rates of return on equity. Since company-owned stores already include manager compensation and other labor cost in operating expenses, it is unnecessary to make further adjustments in constructing the simulated franchisee income statement. It is necessary to assume that the franchisee and hired manager are similarly compensated for their managerial and labor services. The company-owned store, however, does not pay a royalty fee and, therefore, this must be subtracted from what we term gross income to get net operating income before taxes of $51,849 for our average McDonald's franchisee store.

The lower half of Table 4 produces estimated rates of return on equity for various leverage ratios and alternative tax rates of 20 percent, 30 percent and 40 percent. The exercise produces estimates of after-tax return on equity ranging from 12.20 percent to 30.26 percent. This considerable range, in addition to providing an undergraduate level numerical example of the interaction of leverage and tax effects, suggests reasonable rates of return. The Ozanne and Hunt data indicate that, depending how financing from relatives, friends and miscellaneous sources are treated, 50 percent leverage is not unreasonable for a franchised unit in the fast food industry. The appropriate tax bracket will depend upon the circumstances of the individual tax payer,
including deductions, exemptions, tax shelters and other income. Since the $51,849 estimate does not include the franchisee's labor
contribution, that must be included to find the likely tax bracket.
Some very approximate calculations indicate that an average tax rate of
30 percent would not be unreasonable. This tax rate, together with a
50-percent leverage ratio yields a 20-percent rate of return on equity.

As a benchmark we estimated the cost of capital for McDonald's
Corporation, using information from Compustat and McDonald's 10-K
(1978). Again a range of estimates is obtained, in this case depending
upon the growth rate used in estimating the cost of equity capital.
Since McDonald's began paying dividends in 1975, they have grown at 30
percent per year. Although it seems clear that this is not a
sustainable growth rate, we calculated the cost of equity capital
assuming this growth rate for the foreseeable future and then under the
alternative assumption that dividends would grow at this rate for five
years and thereafter approximate growth in GNP. The cost of debt
capital was estimated by calculating the expected yield to maturity on
McDonald's outstanding bonds, using prices on December 31, 1978. Using
these data and McDonald's ratio of debt-to-total assets of 50 percent,
we estimated the overall cost of capital to be in the range of 11.59
percent to 21.2 percent. The cost of equity capital ranged from 18
percent to 31 percent, again depending on the assumed growth rates.
In light of these estimates, the cost of capital supplied by the franchisee seems reasonable and provides little support for either of the extreme views quoted above. While we have not conducted a rigorous comparison of risk adjusted rates of return, it is our judgment that, while 20 percent is a very good after-tax rate of return, it is not exorbitant given the risks involved. It quite clearly does not appear to be a rate significantly below market rate or below the cost of capital for McDonald's Corporation.

If these results can be believed, they have some implications for SBA policy toward franchisee assistance. Had we found that either extreme existed, doubts would have been generated regarding the appropriateness of subsidies in the form of financing assistance to franchisees. If franchisees were providing capital to franchisors at below market rates, this would indicate that the franchisor possesses sufficient market power to extract rents from the franchisee and any subsidy provided by SBA may be captured by the franchisor. On the other hand, if the franchisee were earning exorbitant rates of return on his capital, it would be difficult to justify a subsidy. The above tentative finding of a reasonable rate of return does not imply that the SBA's current policy toward franchising is appropriate, but, at least for this particular franchise system, it diminishes one potential area of attack on SBA financial assistance to franchisees.

We discuss this issue further in the next section.
III. SBA Policy Toward Franchise Operations

The first question is whether the SBA treats franchised operations differently from other small business. The U.S. Senate Hearings on the Impact of Franchising on Small Business (1970, pp. 455-457) states:

Considerable changes have been made in recent years in the procedures for determining the eligibility of franchisees for Small Business Administration assistance. These changes specifically involved the application of size standards to the franchised operation and the interpretation of what is an "independently operated" franchise.

Several years ago, measurement of the size of the franchise was based primarily upon the size of the franchisor. This procedure was later changed and the measurement of the size of the franchise was made directly with the franchise holder. However, this determination of size was dependent upon whether or not the franchise holder was affiliated with the franchisor. This affiliation was based on a list of 30 controls of restrictions that may be imposed on the franchise holder by the franchisor. These controls were considered by SBA as major factors in determining affiliation of the franchise holder. The franchisor's reasons for imposing any one or more of the 30 controls identified by SBA, were to provide for a successful, efficient operation and to protect the franchisor's trademark. However, if the franchise agreement contained a substantial number of the 30 specified restraints, the agreement was considered as causing affiliation and the determination of the size of the franchise would have to be made on the total operation of the franchisor, including its subsidiaries, affiliates and franchisee operations.

In 1965, SBA reduced the number of constraints in determining the affiliations of the franchise holder from 30 to only four. The four restraints were: (1) does the franchisor have the right to tell the franchise holder whom to hire and fire; (2) does the franchisor require the franchise holder to conduct his business in strict conformity with an operating manual issued by the franchisor; (3) is the franchise holder
prohibited from taking out of his bank account more than the specified percentage of his net profits; and (4) does the franchisor determine for the franchise holder the standards of quality, service, protection and advertising. However, this test, as in all previous procedures, apparently prohibited a very large percentage of the franchisees from obtaining loans.

In 1966, following extensive consultations with the franchise industry, as well as public hearings, the SBA Administrator approved a major change in the Small Business Size Standards Regulation relating to franchisees as independent operations. Franchisees are no longer denied small business status for the purpose of obtaining financial assistance on the basis of the controls exercised by the franchisor. The four restraints previously mentioned were removed, and the only test today is as follows: "If the franchisee has the right to profit and risk of loss commensurate with ownership, it is not considered to be affiliated with the franchisor even if the franchisor imposed certain managerial restraints on the franchisee."

Discussion with SBA officials indicated that this test, the right to residual profits (loss), forms the basis of their current policy. A recent review by the GAO confirms that this is basically still the procedure.

SBA considers a business to be small if it (1) is independently owned and operated, (2) is not dominant in its field, and (3) meets the SBA employment or sales size standards. These general criteria apply to franchise operations as well as other small businesses. Other eligibility criteria may also have to be met, depending on the type of assistance requested. SBA's primary concern in determining a franchise's eligibility for a 7(a) loan is whether the franchisee is controlled by the franchisor to the extent that it is affiliated with the franchisor or whether the franchisee has the right to profit, commensurate with ownership, and bears the risk of loss or failure. If SBA determines that the franchisee has the right to profit, the amount of control exerted on the franchisee is secondary. (Comptroller General, 1980, p. 34)
The analysis presented in our paper raises several points concerning this policy. First, if franchising is a method of raising capital for the franchisor, the cost of this capital is a relevant consideration. It may be difficult to justify subsidization of franchisees if they are in turn subsidizing the franchisor. Likewise, if the franchisee is earning exorbitant rates of return, a subsidy may not be justified and, of course, in this case the franchisee may fail on other grounds to qualify for assistance. Our analysis of McDonald's found no evidence of either extremely high or low rates of return to franchisees. However, results may be different for other companies, particularly those in the early stages of their life cycle. Therefore, it would be useful to extend this analysis to other franchise operations, covering a variety of sectors and stages of development.

Second, data necessary to conduct the analysis of cost and availability of capital for franchisors and franchisees would also be useful in assessing the capacity of the franchisor to provide financial assistance to franchisees. The GAO suggests that this capacity may be a relevant consideration in SBA treatment of franchisees as small business, and in individual decisions on whether alternative financial assistance is available.

The GAO report concludes that the SBA is taking undue risks and may be lending funds to franchisees that have not exhausted alternative sources of financing, namely, direct loans from the franchisor or bank loans cosigned by the franchisor. Along with the number of other
recommendations, the GAO suggests "that SBA not make or guarantee franchise loans unless it has evidence that the franchisor cannot guarantee all or part of SBA direct loans or share with SBA guarantees of bank loans made to franchisees" (Comptroller General, 1980, p. 15). On the face of it, the idea has a certain amount of appeal. Presumably, those franchise organizations unable to provide financing assistance would be the ones most needing government help. These may well be the newer and smaller franchisors, while the larger, more mature systems could take care of their own franchisees.

However, we see a number of problems with this approach, not the least of which is the task of determining which franchisors would provide assistance. Some as a policy matter, simply do not provide financing to franchisees and may rather employ scarce capital to finance company-owned outlets. Even if some franchisors agreed to extend credit or participate in loan guarantees as suggested, financing agreements may impose restrictions on franchisees that would reduce their independence. Neither possibility would serve the purpose of promoting small independent enterprise.

Third, the definition of franchising suggests that the right to residual profits (loss) may not be the appropriate policy consideration. Specifically, the essence of a franchise is the existence of a trademark or goodwill. What the franchise contract specifies is the sharing of the rents that accrue to this goodwill and the protection of its value. The primary bargaining issue is the
division of the rents between franchisor and franchisee, not the residual profits that remain after this rent is paid. To illustrate this point, consider a situation in which the franchisor auctions off franchises, which would sell at the discounted expected value of future rents, thereby allowing him to capture all rents. The franchisee would still have rights to residual profit and loss, yet would not share in the rents to the intangible asset, although his capital and labor are contributing to its maintenance.

In practice, perhaps because of imperfect information, franchises are not sold at auction. Rather, the franchisor employs other methods to capture the benefits of the trademark. A common method is to charge a royalty fee based on total revenue of the franchise unit (as is done by McDonald's). There is in this case a divergence in goals between the franchisor and the franchisee, with the franchisor wanting sales maximization and the franchisee presumably wanting profit maximization. The franchisor may urge, coerce or force the franchisee to produce beyond the profit maximizing level of output. Yet, it may appear from the contract that the franchisor is simply taking his cut off the top and that the franchisee has the right to residual profit. In this case, it seems that the degree of control specified in the contract is a relevant consideration, in addition to the SBA's profit-risk test.

One final question that arises is whether franchisors are small businesses, deserving of SBA assistance. Almost without exception they start small, the franchising of gasoline stations being the major
exception, and there are numerous franchisors that are smaller than some franchisees. Yet the discussion is, as far as we can tell, in terms of assistance to franchisees. If capital really flows upstream to the franchisor, perhaps it would be desirable to consider explicit assistance for small franchisors.

IV. Summary and Conclusions

The essence of a franchise is the existence of a trademark or goodwill is produced on a different scale than the product or service. Franchising is also viewed as a method of raising capital for the franchisor. Yet, in what appears to be a paradox, financial assistance flows downstream from the franchisor to the franchisee in about half of the systems for which we have data. We suggest that the different scales of operation, the different nature of the business and the different access to financial markets at the two levels of the franchise make this a reasonable and beneficial arrangement. Data are not currently available to track the flows of funds within franchise systems or to estimate the component cost of capital.

During the past 10 years, the role of franchising in the economy has presented a mixed picture. There have been substantial declines in the numbers of automobile and truck dealers and gasoline service stations at the same time that sales in these sectors have increased sharply, mostly due to escalating prices. These changes reflect developments in these mature industries and any projections into the future must be based
almost entirely on predictions of the magnitude and structure of the automobile and petroleum industries.

In all other sectors, franchising, in general, and franchisees, in particular, continue to grow in importance. While nothing can be assumed to be capable of perpetual growth, the slowdown that some predicted a decade ago does not appear to have materialized. As new franchisors continue to enter the market, there seems to be no marked trend toward the concentration of establishments in fewer firms, and the trend toward buying back, which was noted in the early 1970's, seems to have been reversed in recent years.

Although finding a basis of comparison was difficult, turnover and failure rates among franchisees do not appear to have been especially high or especially low. However, when compared to the appropriate bases, the sources of special uncertainty which face franchisees--failure of the franchisor and the nonrenewal of the franchise agreement at the expiration of its term--are not as inconsequential as they appear to be from an examination of the "raw data."

The existing literature on the advantages and disadvantages of franchising concludes that there are net positive benefits, for society and for the small businessman. Although abuses have occurred, and numerous franchises have failed, and many franchisees earn income less than expected, the consensus of the more serious students of franchising is that it has made entry into small business easier and less risky.
Despite the growth of franchising and the easing of entry into small business, we conclude the movement has not eliminated the need for SBA assistance to small business. In part, this conclusion rests on a lack of direct evidence on the impact of franchising on the cost and availability of small business financing. Also, while franchising continues to grow, significant adjustments within franchising—decreases in gasoline station and automobile dealers and increases in nontraditional sectors—may require substantial financing. Furthermore, the increases in franchisees is not a net increase in small business since the increase in franchised operations to some extent crowds out nonfranchise operations in those sectors. In addition, there are concerns about whether franchisees are really small businesses and whether they should be eligible for SBA assistance. We also suggest that the SBA's profit-risk rule be reexamined in light of the analysis presented in this paper.
Table 1

Franchisee Turnover During 1977

<table>
<thead>
<tr>
<th>Description</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Franchisee outlets converted to franchisor ownership</td>
<td>619</td>
</tr>
<tr>
<td>(2) Franchisor outlets converted to franchisee ownership</td>
<td>839</td>
</tr>
<tr>
<td>(3) Outlets sold by franchisee to new franchisee</td>
<td>7,623</td>
</tr>
<tr>
<td>(4) Franchisee-owned establishments discontinued</td>
<td>5,710</td>
</tr>
<tr>
<td>(5) Franchisee-owned outlets of failed franchisors</td>
<td>1,160</td>
</tr>
<tr>
<td>(6) Franchisee-owned outlets terminated</td>
<td>5,074</td>
</tr>
<tr>
<td>Turnover</td>
<td>16,025</td>
</tr>
<tr>
<td>Total franchisee-owned establishments</td>
<td>190,242</td>
</tr>
<tr>
<td>Turnover rate</td>
<td>8.4</td>
</tr>
</tbody>
</table>

### Table 2

Source of Funds for First Franchised Unit

<table>
<thead>
<tr>
<th>Source of Funds</th>
<th>Franchisees Using Source</th>
<th>Percent $^a$</th>
<th>Percent of Total Funds from Source $^b$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal savings</td>
<td>556</td>
<td>73.5</td>
<td>28.1</td>
</tr>
<tr>
<td>Bank</td>
<td>479</td>
<td>56.0</td>
<td>40.2</td>
</tr>
<tr>
<td>Relatives</td>
<td>201</td>
<td>25.7</td>
<td>7.7</td>
</tr>
<tr>
<td>Franchisor</td>
<td>151</td>
<td>19.2</td>
<td>8.7</td>
</tr>
<tr>
<td>Friends</td>
<td>56</td>
<td>7.1</td>
<td>2.0</td>
</tr>
<tr>
<td>Miscellaneous sources</td>
<td>126</td>
<td>16.5</td>
<td>13.3</td>
</tr>
</tbody>
</table>

**SOURCE:** Ozanne and Hunt (1971).

$^a$ Represents the percentage of all responding franchisees that used each source for some of their funding.

$^b$ Represents the percentage of all funds for all franchisees from each of these sources.
Table 3

Financing Available from Franchisors, 1979

<table>
<thead>
<tr>
<th>Franchisors:</th>
<th>Offering Financial Assistance</th>
<th>Not Offering Financial Assistance</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Restaurants</td>
<td>38</td>
<td>142</td>
<td>180</td>
</tr>
<tr>
<td>All Others</td>
<td>256</td>
<td>265</td>
<td>521</td>
</tr>
<tr>
<td>TOTAL</td>
<td>394</td>
<td>407</td>
<td>701</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Number of Franchisees in System:</th>
</tr>
</thead>
<tbody>
<tr>
<td>With Available Financial Assistance</td>
</tr>
<tr>
<td>Restaurants</td>
</tr>
<tr>
<td>All Others</td>
</tr>
<tr>
<td>TOTAL</td>
</tr>
</tbody>
</table>

Table 4

1,612 Company owned or affiliate owned stores

<table>
<thead>
<tr>
<th>Sales</th>
<th>$1,290,621,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating expenses</td>
<td>$1,072,543,000</td>
</tr>
<tr>
<td>Contribution to profit</td>
<td>$ 218,078,000</td>
</tr>
</tbody>
</table>

Average per company owned stores

<table>
<thead>
<tr>
<th>Sales</th>
<th>$ 800,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating expense</td>
<td>665,549</td>
</tr>
<tr>
<td>Contribution to profit</td>
<td>$ 135,285</td>
</tr>
</tbody>
</table>

Simulated Franchisee Store

<table>
<thead>
<tr>
<th>Gross income</th>
<th>$ 135,285</th>
</tr>
</thead>
<tbody>
<tr>
<td>Royalty fee (10.42% of sales)</td>
<td>83,426</td>
</tr>
<tr>
<td>Net operating income</td>
<td>$ 51,849</td>
</tr>
</tbody>
</table>

Leverage

<table>
<thead>
<tr>
<th></th>
<th>Zero</th>
<th>25%</th>
<th>50%</th>
<th>75%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>$ 0</td>
<td>63,750</td>
<td>127,500</td>
<td>191,250</td>
</tr>
<tr>
<td>Equity</td>
<td>255,000</td>
<td>191,250</td>
<td>127,500</td>
<td>63,750</td>
</tr>
<tr>
<td>Total</td>
<td>$255,000</td>
<td>$255,000</td>
<td>$255,000</td>
<td>$255,000</td>
</tr>
</tbody>
</table>

20% Tax Rate

| Interest @ 12% | $ 0  | 7,650  | 15,300 | 22,950 |
| Income B.T.    | 51,849 | 44,199 | 36,549 | 28,899 |
| Taxes          | 10,370 | 8,840  | 7,310  | 5,780  |
| Income A.T.    | 41,479 | 35,359 | 29,239 | 23,119 |
| Return on Equity | 16.27% | 18.49% | 22.93% | 36.26% |

30% Tax Rate

| Interest @ 12% | $ 0  | 7,650  | 15,300 | 22,850 |
| Income B.T.    | 51,849 | 44,199 | 36,549 | 28,899 |
| Taxes          | 15,555 | 13,260 | 10,965 | 8,670  |
| Income A.T.    | 36,294 | 30,939 | 25,584 | 20,229 |
| Return on Equity | 14.23% | 16.18% | 20.07% | 31.73% |

40% Tax Rate

| Interest @ 12% | $ 0  | 7,650  | 15,300 | 22,850 |
| Income B.T.    | 51,849 | 44,199 | 36,549 | 28,899 |
| Taxes          | 20,740 | 17,680 | 14,620 | 11,560 |
| Income A.T.    | 31,109 | 26,519 | 21,929 | 17,339 |
| Return on Equity | 12.20% | 13.87% | 17.20% | 27.20% |

Source: McDonald's Corporation (1978)
REFERENCES


REFERENCES - contd.


