

NewsWire

April 29, 2009

HELPING ENTREPRENEURS AND BUSINESSES GROW AND SUCCEED

A joint program of the Labovitz School of Business and Economics, Natural Resources Research Institute, and Swenson College of Science and Engineering.

Buyer Beware of "Recession Proof" Franchises

By Keith Girard

As the recession grinds on, millions of people are losing jobs that will never return. Many of the newly unemployed are too young to retire, but may be 20 years or more into their careers. Sadly, this age group -- 40 and older -- faces the steepest odds against finding another job at comparable pay, according to the government statistics.

These graying baby boomers, however, are highly coveted by thousands of franchise businesses, especially if the boomers have a sizable severance check, a six-figure 401(k) account or other assets. Since the downturn began, hundreds of franchises have been marketing themselves as "recession proof." That may have a special appeal for those who have lost their jobs and have nowhere else to turn in what amounts to the worst economic calamity since the Great Depression. But buyers beware.

Franchisors have always marketed themselves as a safer investment than an independent business. In theory, that makes sense. Franchises are supposedly based

Minnesota SBA Honors Women in Business Champion, Elaine S. Hansen

DULUTH – Elaine S. Hansen, Director, University of Minnesota (UMD) Center for Economic Development, has been named the Women in Business Champion of the Year for the U.S. Small Business Administration's Minnesota District Office. The UMD Center for Economic Development is the Small Business Development Center in Northeastern Minnesota serving St. Louis, Carlton, Lake, Cook, Koochiching, and Itasca Counties.

The Women in Business Champion is selected annually to honor individuals who have fulfilled a commitment to the advancement of women's business ownership. Richard E. Braun, Assistant Director of the UMD Center for Economic Development, nominated Hansen for this award.

Since 2003, Elaine Hansen has served as the Director for the UMD Center for Economic Development and the Regional Director for the NE Minnesota Small Business Development Center (SBDC). She is also a certified public accountant (CPA) licensed in the State of Minnesota and in 2003, completed her Master's of Business Administration (MBA) degree from the University of Minnesota Duluth. She has had extensive experience in the public and private sectors working with businesses of various sizes, and had continually worked to promote women in business and women in non-traditional careers.

In the Fall of 1992, Elaine and a friend developed the Professional Women's Network (PWN). The mission of the PWN is mentoring, networking, and sharing information. The network has grown over the past 15 years, one woman at a time. Each year the PWN brings together between 300 and 400 women to network and share information. Each monthly meeting is currently attended by 50 to 70 women.

Over the years, many of the women have made ongoing friendships, mentored each other on business issues, shared information on their



Elaine Hansen, Director, UMD Center for Economic Development receives award from Andrew Amoroso, SBA Economic Development and Loan Specialist

Recession Proof Franchises (cont.)

on proven business models and have the advantage of support networks, stronger marketing muscle and greater brand visibility. Typically, they also have well-developed, standardized business practices that lower the margin for error and increase the chances of success, especially for those without direct expertise in the business.

But a landmark study in the mid-'90s by Wayne State University economist Timothy Bates found that after four years, only 62 percent of franchised businesses had survived, compared with 68 percent of independent small businesses. And independent businesses proved to be far more profitable. Profitability was negative, on average, for franchised firms over the four-year period. Bates also found that the average capital investment for franchisees was \$500,000, compared with \$100,000 for independent entrepreneurs.

A separate, independent study in Great Britain found that franchisee survival rates were also similar to independent start-ups over a five-year period, and that 50 percent of franchisees failed over a 10-year period.

In fact, franchises may have even worse survival rates than independent businesses in the current downturn. Far from being "recession proof," franchises are being hit hard because this slowdown was triggered by a massive failure of the banking system, leading to declining asset values and a nasty credit crunch.

Business Champion (cont.)

businesses, found resources to continue or expand their business, gained encouragement and support through difficult times, and found business and employment opportunities.

The survival of the organization is amazing since it is an all-volunteer organization, with little structure. Realizing that women are very busy and have multiple roles in their lives, there are no attendance requirements and leadership roles are voluntary and continue indefinitely, or until someone steps into the role. Besides being the co-founder, Elaine has provided continuing leadership and has served as the Chair and treasurer for the past 8 years. While many other business-related organizations are struggling to survive, this one is thriving. Without Elaine's interest and continuing involvement, this organization would more than likely not continue to be able to provide the ongoing support that it does for women in business.

Additionally, Elaine has been a frequent speaker in secondary and post-secondary schools on topics of women in non-traditional careers, financial management, and entrepreneurship. She is also known for being a one-person resource and referral network for people looking for information and resources for their business or career.

Uncertainty is Enemy No. 1 for Economic Recovery

We all know that the U.S. Federal Reserve and the U.S. Treasury are trying very hard to bring investors back to the U.S. financial system so they can get out of the markets and resume their normal activities. However, this objective is becoming more and more difficult as time goes by and as the political system continues to meddle with the workings of the markets. I am a convinced free-market economist, but I believe that government intervention is sometimes necessary and this is one of those times. However, investors have lost so much money since this crisis started that they are not going to come back to the U.S. financial system until they are guaranteed that the rules of the game are clear and that they can make a conscious and rational decision on whether they are going to invest in this market or not.

But what is happening today in the U.S. financial sector is all but clear. Politicians are overreaching their regulatory boundaries on the argument that the taxpayer's money is at stake and that they are representing the taxpayers. Thus, the limits between the political system and the economic system have become blurred, and it is very difficult to know what is going on. Much of the credit thawing that has happened in the market since last year is just a "mirage" provoked by the direct intervention of the U.S. Federal Reserve in some of these markets. However, if the Federal Reserve would leave the markets today, I believe markets would freeze back up once again. This seems to be clear just by looking at the spreads in the corporate bonds market, which remain at almost the same levels they achieved immediately after the Lehman Brothers collapse, compared to the clear "Fed-led" improvements in the commercial paper and mortgage markets since the Federal Reserve started intervening in these markets.

While I understand the frustration of many regarding the current environment, we have to agree that the commercial banking system is just one piece of the

Recession Proof Franchises (cont.)

Franchises typically require a large outlay of cash to get started and maintain operations. As such, many franchisees start out heavily in debt, and rely more on credit lines and loans.

Like a receding tide that exposes dangerous rocks just below the ocean's surface, the slowing economy is also exposing onerous or exploitive franchise agreements that, in many cases, are leading to bitter lawsuits and bankruptcies

Among the sore points in the current downturn are franchisor estimates on startup costs and profitability. In a lawsuit against Noble Roman's Inc., 14 franchisees of its Noble Roman's Pizza and Tuscano's Italian Style Subs shops are seeking \$8 million in damages, claiming the company misled them about costs and profit potential of its stand-alone restaurants.

One restaurant franchise in Kentucky closed in August 2007 after failing to come close to the chain's claim of \$100,000 per year in profits, while startup costs exceeded the chain's estimates by about \$100,000. Another California plaintiff claims she suffered \$450,000 in operating losses over a two-year period and said her startup costs were more than three times the chain's estimate of \$236,000. Another franchisee lost \$200,000 in savings and is still \$219,000 in debt after his store failed.

Other franchise-agreement provisions, nettlesome in good times, can turn deadly in a downturn. Franchisees of Quiznos restaurants claim in a lawsuit that

Uncertainty is Enemy No. 1 (cont.)

puzzle in the current crisis; others are the investment banks, mortgage banks, politicians, regulators, risk rating companies, etc. Everybody has its share of the blame for the current crisis.

During a question-and-answer section of my last speaking engagement, a person from the audience asked me a very good question: how can investors decide on the worthiness of an investment if politicians, not markets, are determining the winners and losers in this economy? I think the question is a very good one. How can we expect private capital to fund the recapitalization of the banks, which is the only way the economy is going to start growing again, if political decision makers are the ones behind the success or failure of these firms? And even if we allow markets to work again and decide the correct or optimal allocation of resources, it will take a long time to bring back the financial system from the brink of collapse. And that's why economic recovery will take a while longer than what most believe today.

U.S. Consumers: From Buyers to Fixers

Something interesting is happening in lieu of this new economic environment. While reading an on-line newspaper, an article caught my attention. The article argued that the latest "boom" in a town was the "auto repair business" as well as selling used tires. It is true that the particular town has been severely affected by the demise of the U.S. auto manufacturing sector, but the point is still valid: more people are fixing their cars today rather than exchanging them for a new car as it used to be the case before the crisis. And this could very well be the new trend in the economy, especially if the economy takes a while to recover and consumers keep on saving as they have been doing for the last several months...to the dislike of many who are trying to bring interest rates down so as to spur the new wave of consumption and indebtedness.

In fact, this FMS ties with two others I wrote last year (see the FMS for July 14, 2008 and August 11, 2008) that argued that the crisis may change the way consumers behave and that firms will no longer be looking at the U.S. consumer to be the trendsetter in terms of innovation. Will this crisis be so severe that it will affect the pace of industrial/service innovations? If we are to believe the recent news that Americans, once considered the most mobile labor force in the world, have slowed down the rate at which it changed living places, then the crisis is already having a large impact on the "American way of life." If so, then the best investments will probably be on those firms that "fix" what we already have. Are we going to see more TV repair shops or shoe repair shops, etc., making a comeback into our economic landscape? The answer: probably not. In fact, for this to happen it will be necessary to see a very steep decline in this pace of innovations such as to prevent prices of those goods that are in the market today from losing their value. That is, one of the first indications that we may be reverting to a "repair shop based economy" would be if we see less turnover of models, that is less product/service innovation, because whenever a new model/product innovation comes in, it displaces the previous one and its price drops, making fixing the old one a waste of resources. I remember I had to change my Palm phone because the antenna wasn't working properly (I have always wondered whether the antenna's short life span was determined by the manufacturers ahead of time, one of those conspiracy theories of mine!) and fixing it would have cost much more than buying a new, and improved, phone under a new two-year contract.

Recession Proof Franchises (cont.)

they are being hammered in the current economy by disproportionately high costs for commodities that they must buy from the organization or designated suppliers.

They also criticize Quiznos for lackluster marketing efforts, engaging in a promotional war with much-larger Subway, which is crushing their margins, and imposing a cost structure that isn't suited for the weak economy, according to the franchise Web site bluemaumau.com. Separately, the chain is being sued in three class actions for overcharging for food and other supplies, according to *Advertising Age*.

Many franchisees have been required by their agreements to locate in strip malls and other high-rent locations, which are proving problematic now. Landlords are often loathe to renegotiate leases and think franchisees have deep pockets. In fact, franchisees may have less flexibility under their agreements to raise or lower prices or may see their margins crushed in other ways. One Quiznos franchisee said 40 percent of his sales had to go directly into advertising, royalties and food for the next week.

By one measure, last year was bruising for franchises. The number of franchise failures that led to defaults on Small Business Administration 7(a) and 504 loans increased by 43 percent, according to a widely quoted report by Coleman Publishing in La Canada, Calif. Franchise-related SBA loan losses topped

Continued in column on right

U.S. Consumers: From Buyers to Fixers (cont.)

However, I sincerely doubt that the effects of this crisis will have such an impact on our newfound ways of living. But we shouldn't say, "Never again". Remember, we used to be very boring before we started changing our cars every 2 years, our phones every year (or even less, depending on the rate of innovation), our computers every two to three years, etc. However, today's income, credit, debt, employment and consumption environment are the perfect ingredients to go back to old ways of living. If this happens, it will be a shock for the entitlement generation who still has a hard time understanding how we survived if we didn't have PCs, Internet, cell phones (one per family member) and two to three cars per household. I will probably survive, but will they?

Both articles, **Uncertainty is Enemy No. 1 for Economic Recovery** and **U.S. Consumers: From Buyers to Fixers**, were written by Eugenio J. Aleman, Wells Fargo Economics. For more FINANCIAL MARKET STRATEGIES: www.wellsfargo.com/com/research/economics/index

Recession Proof Franchises (cont.)

\$93 million in 2008, a 167 percent increase over the previous fiscal year.

Although franchisors and their trade groups routinely sponsor studies on the effectiveness of their industry, in reality many are nothing more than carefully crafted sales pitches. Franchise agreements almost always favor the franchisor, and may not be suitable or flexible enough for a franchisee to operate, especially in difficult economies. Contracts are binding and difficult to get out of.

The bottom line is not all franchises are created equal. Despite some general protections offered by federal and state franchise laws, it's still a buyer beware business.

The University of Minnesota Duluth Center for Economic Development offers numerous workshops to help entrepreneurs and employees operate more efficiently. All workshops are held at the Duluth Technology Village, 11 E. Superior Street, Suite 210 unless otherwise noted. To register call: 218-726-7298, 888-387-4594 or register online: www.umdced.com/workshops.

The mission of the University of Minnesota Duluth Center for Economic Development is to assist entrepreneurs and businesses to grow and succeed.

Funded in part through a cooperative agreement with the U.S. Small Business Administration, Minnesota Department of Employment and Economic Development and sponsoring centers. Reasonable accommodations for persons with disabilities will be made if requested at least two weeks in advance. For arrangements, contact: UMD Center for Economic Development, 11 E. Superior Street, Suite 210, 218-726-7298.

1986 – 2009 Celebrating 23 years of excellence and also recognizing UMD's 25 year partnership with the Minnesota Small Business Development Centers

The University of Minnesota is an equal opportunity educator and employer. To unsubscribe to this electronic newsletter please email ced@umdced.com