

Bryan K. O'Rourke, MBA  
Clint Lee

# FRANCHISING: DISPARITY IN NUMBERS

A CLOSER LOOK AT INDUSTRY REPORTS  
AND THE REALITY BEHIND THE NUMBERS





# Franchising: Disparity in Numbers

A closer look at common franchising industry reports and the reality behind the numbers.

**Clint Lee**

**Bryan K. O'Rourke, MBA**

Many people get into franchising on the belief that the statistics show it as an easy way to expand their company. In reality, it's neither as easy as people think nor as the statistics show, given that a handful of brands comprise a majority of the statistics. The keys to success in franchising are the same as in most industries: having competent people, a sound and proven business model, and applying continuous process improvements.

Please note that the purpose of this paper is neither to discourage nor endorse franchising as a method of expansion; it is only to discuss the reality and interpretation of much of the information which is published on the subject of franchising. Franchisees, franchisors, and anyone who is potentially interested in becoming either relies heavily upon information that can, at best, be described as obscure. Much of the data that is currently distributed regarding franchising either has its origins in franchisor-funded studies or is distributed to potential franchisees by those with a vested interest in selling franchises or selling services to franchisors. It is understandable that the data presented in these reports could be overly auspicious in its portrayal of the franchising industry.

The obscurity of the information contained in some of these industry reports can lead to a poorly aligned expectation for both franchisors and franchisees. Inordinately positive statistics of franchising industry growth rates and success metrics can create a misunderstanding by many new franchisors as to the true length of time that it might take to successfully grow a brand through franchise expansion and at what cost. Alternatively, potential franchisees often view purchasing a franchise as a low-risk way of entering the world of business ownership.

There is objective research that has been published regarding success and failure rates of franchising and this information can differ greatly from that which is commonly reported and distributed among the industry. Our intent is to delve further into the disparity in these numbers in an effort to help others make better informed decisions.

## Introduction

Over the course of the past 30 years franchising - particularly in the retail sector - has gained popularity as a method of expansion. The appeal of franchising to the potential franchisor is strong because it portrays a possibility for rapid growth over a short period of time without the necessity for a large capital outlay. For a potential franchisee, the idea of purchasing a franchise is enticing, when weighed against starting an independent establishment, because it seemingly allows the franchisee to share in the upside earning potential of being a business owner while their downside is hedged by being part of a “proven system”, thus offering a low-risk opportunity to enter business ownership.

These paradigms are extremely prevalent today and are in fact perpetuated by an industry that benefits from their existence. However, further investigation into studies that have been conducted on the franchising model reveal a much different reality than is most often reflected in reports found in mainstream publications.

The rate of success and failure of franchised establishments versus their independent-business establishment counterparts has been a source of exploration for some time. There have been a handful of studies commissioned on the subject, some through trade associations and others through academia, with a surprising (or perhaps not) disparity in the resulting numbers. Somewhere in the midst of all of the reports, numbers, facts, figures, and regression analyses there lies a true reality, and that reality has serious implications for all involved - franchisors, franchisees, and especially those weighing the option of becoming either one.

Let’s look at two of the most common paradigms in franchising today:

In the article, Franchising: Promises, problems, prospects, Dr. Shelby D. Hunt makes the observation that “an entrepreneur with only a small retail establishment, or perhaps, only an idea or concept for a business, could build a large and profitable organization around that idea, concept or establishment. Since franchisees customarily put up most of the capital for their units, a franchisor with very little capital of his own could create a large chain rapidly.” This notion can be seen in many startup franchisors as they launch their franchise programs after operating only a single establishment or perhaps just after creating a conceptual idea.

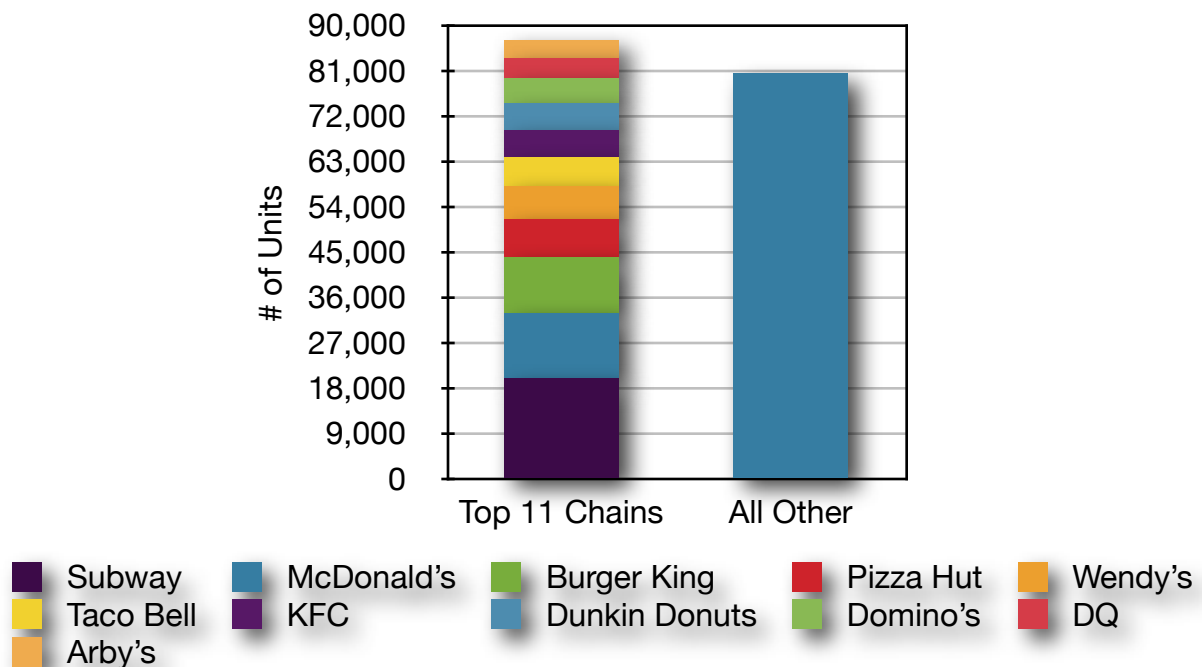
On the other side of the coin, for franchisees, the idea of hitching your wagon to a brand with an established trademark, a “tried and true” proven operating system, and garnering access to capital, training and support appears to take much of the inherent risk out of starting a business. This thought process is in fact the very basis of most franchisors’ marketing campaigns targeted toward prospective franchisees.

But are these assumptions accurate? Upon what empirical evidence are they based? Can a person entering business ownership for the first time accurately draw any conclusions about their potential for success utilizing the industry published reports that are available?

## The Pareto Principle Applied to Franchising

The Pareto Principle is an important concept to understand especially in the context of this paper and further data analysis. The Pareto Principle, also commonly referred to as the 80-20 rule, states that for many events approximately 80% of the effects are brought about by 20% of the causes. Its origins are from the observation of Vilfredo Pareto, the 19th century Italian economist, who noted that 80% of the land in Italy was owned by 20% of the people. Think about this in the context of business: 80% of your revenue comes from 20% of your franchisees; 80% of your sales are generated by 20% of your customers; 80% of your complaints come from 20% of your units, and so on.

It is interesting to see how this principle applies to franchising statistics. In the United States today, there are an estimated 3,000 franchisor companies operating or franchising approximately 854,511 establishments<sup>1</sup>. Upon a closer examination it is apparent that the vast majority of these establishments are controlled by a minority of brands. For example, within the quick service restaurant industry alone, which is the largest sector in franchising by number of units, there are an estimated 182,136 establishments in the United States that are part of a franchise system (either franchisor-owned or franchisee-owned). As illustrated in the chart below, nearly 50% of these establishments are operated by just 11 brands.



**Figure 1: Quick service food is the largest sector in franchising in terms of the total number of establishments. A study of the distribution of establishments per brand reveals that nearly 50% of all units in this sector are operated by only 11 brands.**

<sup>1</sup> PriceWaterhouseCoopers, Franchise Business Economic Outlook 2009

Think about it this way. According to some estimates there are upwards of 500 brands in the quick-service restaurant sector that are engaged in franchising. Of these 500 brands, 11 of them, or 2%, control about half of all the establishments in the sector. Compiling a list, in order of size, of the top 20% of the largest franchise systems in this sector would certainly account for above 80% of the total establishments in the sector. To look at it from the other side, 80% of the franchise systems in the quick-service food sector operate less than or equal to 20% of the establishments.

**“THE POTENTIAL FRANCHISEE WHO RELIED UPON STATISTICS SUCH AS THESE TO JUDGE THE RELATIVE RISK OF FIRM FAILURE IN FRANCHISING, AS OPPOSED TO INDEPENDENT BUSINESS FORMATION, IS SIMPLY NOT RELYING UPON INFORMATION THAT IS APPLICABLE...”**

Another illustration of this is in the Rosenberg International Center of Franchising’s RCF 50 Index. The Rosenberg Center has developed, and tracks, an index of 50 publicly traded U.S. franchisors. According to their website, “These 50 franchisors represent over 98% of the market capitalization of all US public companies engaged in business format franchising. From a universe of close to 140 US public franchisors that it tracks in its Global Franchisor Database, the Center has identified the top 50 US public companies involved in business format franchising...” By The Rosenberg Center’s math that means that 35% of the publicly traded U.S. franchisors control 98% of the market capitalization.

The implications of this concept are enormous to one who is seeking information about the performance of the average franchise system. Essentially, what this means is that the vast majority of franchise systems (brands) in a sector are statistically insignificant with respect to the overall performance of that sector. For many newcomers to franchising, utilizing these broad based statistics to make generalizations about the overall health of franchise systems would be incorrect.

## **Economic Impact Studies**

In 2004, the International Franchise Association commissioned a broad study of the impact of franchising on the U.S. economy which was conducted by PriceWaterhouseCoopers. The information contained reflected data from 2001. In January 2008, Volume II of this report was released which reflected data from 2005 as well as growth statistics over the period of 2001-2005.

The data and subsequent key figures that are highlighted by the International Franchise Association in the report show that, from 2001-2005, the franchising industry sustained 18.5% growth in establishments, 41% growth in output, 12.6% growth in jobs, and that in 2005 franchising was an \$880.9 Billion industry.

At a high level glance these statistics seem to reflect an industry, or really an expansion method, that has a large base of growing and healthy participants. One might interpret this data to mean that a majority of franchise systems are expanding, in terms of both establishments and output. However, to conclude that the majority of franchise systems are performing well, based on this information, would be conjecture. The study really reflects the performance of a small minority of companies who control a vast majority of the establishments and is not applicable in determining the overall health and viability of the majority of franchise systems in the United States.

## Franchise Postulation

There are many axioms that circulate within the franchising community which pertain to the success rates enjoyed by franchisees over their independent-business owning counterparts. Many of these unfounded “facts” cite reasonably trustworthy sources such as the U.S. Department of Commerce, the U.S. Census Bureau, and the U.S. Chamber of Commerce, but there are no empirical data sets or reports to corroborate the information.

A brief Google search of franchising websites will undoubtedly present you with a list of results. Here are some of the most commonly recurring statistics that we identified:

- \* *A 1999 study by The United States Chamber of Commerce found that 86% of franchises opened within the last five years were still under the same ownership and 97% of them were still open for business.*
- \* *A U.S. Department of Commerce study conducted from 1971 to 1997 showed that less than 5% of franchise businesses were closed each year.*
- \* *The U.S. Department of Commerce states that 90% of franchises are still in operation after 10 years, compared to just 18% for other forms of small business.*
- \* *Franchised businesses enjoy a 95% success rate.*

## Academic Studies

There have been a number of academic research studies conducted on franchising over the past 30 years covering a range of topics from resource scarcity to agency theory to franchisor success and franchisee discontinuance rates. However, these studies are not highly circulated throughout the franchising community.

What's most intriguing about these studies is their intentions, or perhaps lack thereof. As is appropriate with these types of studies the research methodologies are outlined in detail and the report's conclusions and data itself is subjected to peer review that allows for a self-policing discussion to occur. Academic studies are set forth to test hypotheses using objective research methods and therefore the potential for biased outcomes should not be a factor.

Dr. Timothy Bates conducted a research study, which was published in 1995, to examine franchisee survivability rates. His study was one of the first of its kind to draw a distinction between franchised units owned by single-unit owners versus those owned by multi-unit owners. The basis of this examination was to determine if the extant paradigm, which was that an entrepreneur can mitigate the risk of failure by choosing a franchise over an independent start-up, was an accurate presumption. It's important to note that research prior to his lumped all franchised units together, making no contrast between young or old, franchisee- or franchisor- owned. What's the significance of this? Well, ponder this question for a moment: If a multi-unit franchisee who has been operating for 10 years and owns 10 Subways opens an 11th location, is the probability of success for that particular unit equal to the probability of success for a new single-unit franchisee opening his/her first unit? The answer, according to Bates' study, is no. Most logical people with experience in franchising would agree.

Therefore, it is important to gain clarity and understanding as to what the probability of success is for a newcomer franchisee. What Bates found was that within 4 years of inception, of the firms included in the study, 61.3% of those operating franchised units were still in operation. Compare this with 73.1% of those operating independent, non-franchised units still in operation within the same 4 year period. Another insightful finding was that firms who purchased existing franchised units as an entrance into business ownership were particularly at risk. Only 52% of the firms that purchased an existing franchised unit as entrance to business ownership were still in operation within 4 years.

Bates had this to say referencing two other studies about franchisee survivability, one of which was published by the International Franchise Association, "The potential franchisee who relied upon statistics such as these to judge the relative risk of firm failure in franchising, as opposed to independent business formation, is simply not relying upon information that is applicable to the issue of new firm survival in franchising."

A study focusing on franchisor success rates, over a twelve year period, was published in 1998 by Francine LaFontaine and Kathryn Shaw. The findings of this study concluded that only 28.6% of franchisors were still in business after a 12 year period. They also found that in the period of their study there were 2,524 companies that began franchising, while 1,941 of those quit franchising during the same period. That attrition rate comes out to be nearly 77%.

The following is an interesting excerpt from the LaFontaine and Shaw study. It pertains to the Pareto Principle set forth above whereby a majority of franchised establishments are found within a minority of franchise systems.

*“From the perspective of franchisees, the amount of exit found here suggests that in the majority of systems, franchisees cannot expect that their franchisor will be around for the whole duration of their contract - which averages about 15 years according to the Department of Commerce. This does not mean that the majority of franchised businesses will find themselves in an “exiting” system - a small minority of very well-established franchisors accounts for the majority of franchised businesses, and these are likely to remain successful for years to come. But entrepreneurs buying franchises from less established systems are likely to face franchisor exit, either failure or departure. This paper confirms that franchisees should thoroughly investigate the franchise system they want to invest in, going beyond the information about royalty rates, advertising rates, rankings, etc. found in franchisor directories, and toward more product, market, and other less easily accessible information about the chain.”*

A study conducted by Dr. Scott Shane (1996) resulted in similar results. His research showed that after a 10-year period only 24.6% of companies who had begun franchising were still doing so. The majority of the companies did not make it through the first 4 years with over 57% ceasing to franchise in this time frame.

## **Conclusion**

The franchisor-franchisee relationship is a very complex one, but the fundamental basis of the relationship is that a firm, the franchisor, has developed a business format comprised of a proven product, and a system of delivering that product to the market that is profitable; this proven product and system, or set of systems, is offered to another firm, the franchisee, in exchange for the payment of an initial upfront fee and recurring royalties. The underlying assumption is that the franchisor is able to expand the system without bearing the unit-level development costs necessary for each location or incurring the costs associated with managing each individual unit; while at the same time maximizing the revenue and profitability of each location by having the most incentivized person (the owner) running the unit. From a franchisee’s perspective, franchising offers the opportunity for a small business owner to associate their business with a larger organization that has an established brand name, a proven product and method of delivering that product to market; while also gaining access to capital, training, and support that they might not have otherwise had, thus lowering the risk of failure for the small business owner.

However, as we have outlined in this paper much of the academic research conducted on individual franchisor-franchisee success rates is contradictory to what is typically published and disseminated about the overall industry. The main contributing factor to this is evident in the Pareto Principle, whereby the minority of franchise systems tend to skew overall franchising industry results. If the largest 20% of franchise systems grow over a given period of time then the overall industry numbers will reflect that growth.

Typically, the franchise systems found in this top 20% are older, more established chains, with high brand awareness, and have a large base of multi-unit franchisees who are opening additional units. These circumstances essentially render this type of reporting inapplicable in attempting to gauge the health and viability of the majority of franchise systems. An individual, or company, attempting to enter franchising for the first time certainly can not look at these industry reports as any sort of predictable measure of success.

The truth is that there is a fair amount of misinformation and misinterpreted information circulated regarding franchising. The intent of this paper is to shed light and engage discussion on some of the realities of the franchising business model, both for franchisors and franchisees, in an effort to assist others in properly evaluating the franchising model. Whether a company is contemplating expansion through franchising its concept, or an entrepreneur is evaluating a franchise system against opening an independent business; understanding the realities and complexities of both can lead to better decision making - which over time can lead to a healthier and more prosperous industry overall.

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Clint Lee is a Principal at The Flywheel Group. You can find more of his thoughts on [The Flywheel Group blog](#).

Bryan K. O'Rourke, MBA is also a Principal at The Flywheel Group. He maintains a well-respected blog at [www.bryankorourke.com](http://www.bryankorourke.com), and you'll also find more of his writings on franchising at [The Flywheel Group blog](#).

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