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THE ROI FACTOR:

**UNDERSTANDING THE BOTTOM LINE IN THE
SUCCESS OR FAILURE OF FRANCHISE SYSTEMS**



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Preface

The franchise industry spends considerable energy addressing various facets of system expansion and management. Yet, the bias towards growth that showers attention on the “hottest” franchise concepts, defined by the number of development units being sold or opened, bypasses a better measure often lost in the mix: the return on investment the franchise opportunity generates. The unique and holistic solutions that The Flywheel Group utilizes can help cut through the clutter franchisors and franchisees experience in order to more effectively address and impact the most fundamental component of success for any franchise system: return on investment.

ROI and Franchising

In finance return on investment, “ROI”, is the ratio of money gained or lost on an investment relative to the amount of money invested. The amount of money gained or lost may be referred to as interest, profit/loss, or net income/loss. The money invested may be referred to as the asset, capital, principal, or the cost basis of the investment. In franchising the investment would include all of the capital required to open and operate the business, no matter if the source was debt or direct cash investment. ROI does not indicate how long an investment is held and it is most often stated for a calendar or fiscal year. ROI as a measure is a simple way to compare one investment's performance with another.

The implications of ROI in franchising are profound and have unique effects on franchisor and franchisee behaviors. From the franchisor perspective, ROI should theoretically drive the creation of a unique model addressing a distinctive market while generating superior profitability.

From the franchisee perspective ROI theoretically defines the appeal of one model as opposed to other models available for the investment by the franchisee of both capital and personal time and effort.

Essentially the franchisor-franchisee relationship is an economic exchange whereby a franchisee submits capital and time in exchange for an implied superior economic return which the franchisor system provides. Ironically, while this economic description is the essence of franchising, the most relevant component, ROI, is often overlooked or at least not emphasized enough, either by franchisors or franchisees. Thus, many challenges that franchise systems face are really symptoms of failing to be true to the essence of the economic relationship which the franchise represents, with ROI being the ultimate measure of success.

Franchisees' Assessment of ROI

Success in any relationship is most likely achieved by each participant being clear about their goals. However, for a host of reasons many franchisees do not objectively evaluate their goals from an ROI perspective. Potential franchisees or a franchisee already engaged in a franchise system, must define what their ROI objectives are. This is a more complex task than one might first assume it to be. There are three main considerations to keep in mind when identifying ROI objectives for a franchisee: comparable investment returns, the time horizon for a liquidity event or exit, and the premium required for the investment of personal time and effort required by the franchise. All of these variables must be weighed and are unique to each franchisee.

With respect to comparing alternative investments, consider passive investments in stocks or bonds. There is, for example, a correlation between risk and return and the market's supply ample and varied information enabling meaningful comparisons. Historical analysis enables one to reasonably conclude expectations on returns. For example, it is generally accepted that investments in equities yield 12% annual returns over time. Low risk investments such as treasury bonds yield approximately 5% for maturities of ten years. A franchisee should expect significantly higher returns than these passive investments due to risks and additional investments of personal effort and time.

In addition, unlike investments in publicly traded stocks or bonds that can be cashed out at any time, the franchisee must be aware of how he or she could ultimately sell the business and what price could be expected. This is often overlooked by franchisees and can have a significant impact on the ultimate ROI the business generates over time. For example, if a stock paid a 12% dividend each year for ten years but the value of the stock was worthless when the owner tried to sell it, the ultimate average ROI would be far less than the 12% being paid annually. The market for selling a franchised business can vary a great deal and will have a significant impact on the ultimate return the franchise opportunity generates. This is particularly important when assessing immature rapidly growing, smaller franchises, where there is inadequate history to ascertain what the resale market for the franchise might be, let alone what predictable income the business can generate.

The bottom line for a franchisee when considering ROI is that the franchise opportunity should provide considerably higher yields than those earned in a passive vehicle. While ROI in franchising varies significantly, annual income should be no less than 30% percent per year of the total initial investment for the business, including all debt and working-capital reserves needed to start the business. In fact an appealing concept should, if properly managed, reach the 50% cash on cash return level. Interestingly, in many franchise systems, prospects are not adequately evaluating the ROI equation which means they are not really clear about what their objectives are. Thus, many dysfunctional franchise relationships that undermine a system's success are generated by a lack of evaluation. The ability for a quality franchise relationship to evolve is therefore greatly compromised.

Franchisors' Duty to Deliver ROI

As this paper addresses, the ultimate responsibility of the franchisor is to deliver a unique model which addresses a market where superior profitability can be generated. As with many franchisees that inadequately assess their ROI requirements, many franchisors do not understand the implications of the ROI formula to their success and therefore waste great effort on matters that do not bear on this essential deliverable. Some of the major strategic failings that franchisors undertake relative to delivering superior ROI are: i) Growing too quickly without understanding the ROI model; ii) a lack of expertise to assess and impact the ROI model and;

iii) failing to insure that prospective franchisee candidates are adequately assessing ROI as part of their consideration of becoming a franchisee.

Rapid growth is a double edged sword and a common challenge that franchisors face in attempting on the one hand to seize the market momentum their concept's unique attributes generate while simultaneously attempting to grasp the economic dynamics of their ROI model. There are many instances of rapidly growing chains, like Boston Market among others, who made assumptions about their ROI model without clearly understanding the financial dynamics afoot. Rapid growth, while implied by the industry to be an indicator of success, can also be a breeding ground for massive miscalculation regarding ROI.

One example of how growth can adversely impact the ROI model is when undisciplined geographic expansion ensues. Cost of operations and investment requirements can vary significantly in different regions. Undisciplined franchisors who expand into new markets without having evaluated cost variations can unwittingly throw their franchisees to the proverbial wolves. There are also regionalized business considerations involving customer preferences among other variables that often have a direct impact on revenues, thus rendering the extant ROI model irrelevant.

Another significant problem exhibited by some franchisors in addressing the ROI model is a lack of expertise. ROI is a function of a combination of factors which together create the model. There is rarely a silver bullet. Capital investments, revenues, operating expenses are all functions that contribute to financial results and are the soul of a franchise system. Many franchisors, particularly in small to mid-sized systems, assume that they adequately understand the nuances of these and other dimensions of their businesses. Yet, it is highly unlikely that a management team in a small to mid-sized or even larger franchisor possess the expertise to create cutting edge system enhancements. Consider this, a 5% improvement in revenues, cost reductions and operating efficiency can combine to take a mediocre opportunity and make it a superior ROI performer. Ultimately, this attention to detail is the difference between success and failure and many franchisors do not utilize experts in important areas of their concept to make a positive impact on ROI because it takes work on every aspect of the franchise model.

A final dimension of the ROI equation for franchisors is making certain that prospective franchisees are meaningfully weighing the financial outcome of their investment of both time and capital. Regrettably many franchisors, in the interest of quick expansion or for a variety of other reasons, do not adequately insure candidates are evaluating the ROI equation. Most dissatisfaction experienced by franchisees results from having a lack of clear objectives. Yet, all too many franchise sales are concluded in an improper context. This dynamic creates a burden on the franchise system exhibited through increased franchisee “Churn” rates and stalling growth rates.

Conclusion

This paper explores but a few of the dynamics that ROI represents in the franchisor and franchisee relationship. The strategic and practical implications of this financial measure are significant. Further implications and thoughts, including an assessment of your systems reliance and evaluation of its ROI model can be supplied by contacting The Flywheel Group.

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

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