How Recession Helps Franchise Sales

The worst of times or the best of times:
What drives franchise sales?

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It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to heaven, we were all going direct the other way - in short, the period was so far like the present period . . . – Charles Dickens, A Tale of Two Cities

With all the negativism that is making headlines these days, it is difficult sometimes to maintain perspective.

Foreclosures at record highs. Nearly a trillion dollars in bailouts. The Dow with record declines. Mass layoffs and unemployment at five year highs. Reading Dickens, it seems that perhaps he only got it half right.

But for franchisors, truer words were never spoken. Yes, there are some short term difficulties that will take time to flush through the system. At the same time, however, there are a number of reasons to anticipate that the best of times are right around the corner.

Perhaps the best place to gain this perspective is by understanding what drives franchise sales.

There are, of course, thousands of factors that drive franchise sales at the micro level. A bad day at the office. The overbearing boss. A neighbor's franchise success story – and perhaps their new Mercedes. The cancelled flight that leads to the missed soccer game.

But, at a macro level, there are three predictable factors that lead to a surge in franchise sales activity – and many of them are pointing to a franchise boom on the horizon.

The first and foremost factor affecting franchise sales is a rising unemployment rate and the fear of losing one's job. At 6.1%, the unemployment rate has increased by 1.4% in the last 12 months alone – adding 2.2 million unemployed to the marketplace. And some economists are predicting that it will hit 7% before it turns around.

While that news is terrible for the economy and it sounds terribly callous to even mention it, what this means for franchisors is a larger pool of franchise candidates.

Every 0.1% increase in the unemployment rate adds another 150,000 prospective franchise buyers to the marketplace. As these newly unemployed hit the market,

many will dutifully send out resumes and try to network their way into a position. But for many, the sad truth is that they will never be able to replace their past level of income by working for someone else. And after a few months of futility, many of these formerly employed will come to the realization that the only way that they can hope to get back to their previous levels of income will be to start a business of their own.

But most of the recently unemployed who start a new business are not entrepreneurial by nature. If they were truly risk-takers, they would have started their own business years before. Some will go the low cost route – convert their spare bedroom, hang out a shingle, call themselves a consultant, and hope they can survive until the economy turns. But many – especially those at the higher end of the pay spectrum who do not see their jobs coming back – will come to the conclusion that building a real business is the only remaining option for them. And often, they will want the proven systems and support that is afforded them by franchising.

Consider mass layoffs – a statistic that is kept by the Bureau of Labor Statistics that represents companies that have more than 50 reported claims for unemployment insurance. These mass layoffs come from the country's biggest companies. And it is precisely these companies that are most likely to provide their employees with some type of severance package that could fund their initial venture into business ownership.

According to the Bureau, September mass layoffs alone added 235,681 to the unemployment rolls in 2,269 mass layoff events – the most since September of 2001. Since the beginning of the year, the 14,811 mass layoff events have added over 1.5 million to the ranks of the unemployed – the highest number since 2002. And these numbers do not count those that take an early retirement with a nice package. If these trends continue, there may be another million prospective franchisees entering the market before things get better on the employment front.

Even those employees that are left behind are more likely to jump ship – or plan for it in the near future. As these "near layoffs" see their friends and relatives heading for the unemployment lines, they become increasingly concerned about their own job security. And in the process, many will recognize that the only way to be in control of their own destiny is through business ownership.

The second major factor affecting franchise sales is the stock market. Again, bad news for the economy can mean good news for franchisors. Back in the days of the "Internet bubble," franchise salespeople often found it difficult to pry people's money out of the market. And with good reason! Many investors, seeing spectacular (if speculative) returns in the market, figured in a "what-goes-up-must-keep-going-up-forever" mentality that all they had to do was to hold on to their shares of Amazon, and they could retire millionaires in a few months. When the bubble burst, money flew out of the market – and, in many instances, into franchises.

Today's market has seen similar flights to cash. Many investors have already fled the market, and there may be more to come. Those that are sitting on the sidelines will soon realize that there is a need to put their capital to work. But given the wild gyrations of the stock market and the fear that has driven many away, it seems

unlikely that many investors will be jumping back into stocks anytime soon. Again, franchises and small business ownership offer a potentially high return alternative.

The third driver of franchise sales is credit availability. This is where the current news isn't very positive. The combination of reduced home values, reduced equity, and decreased credit availability has forced some buyers to consider less expensive franchises and has driven some out of the market entirely.

But even this bad news is not disastrous – at least for most franchisors. Franchise prospects that once looked at million dollar investments are still looking for franchises – only they are now looking at investments in the $500,000 range. And while franchisors with investments in the million dollar range on up are feeling the pinch, this "push down" effect is helping to offset the credit crunch for franchisors with smaller investments.

Moreover, even franchisors with large investments are still making franchise sales – and almost all of these new franchise sales are financed.

Yes, credit is tighter. But deals are still getting done. Today's lenders are simply looking for a better quality borrower. A couple of years ago, lenders would be happy to consider borrowers with FICO Credit Scores of 620. In today's market, they require a FICO 680 or better. But bear in mind that the national average Credit Score is 692.

Today's lenders are also looking for 30% equity participation in franchise purchases. Again, several years ago, franchisees could purchase franchises with as little as 10% of the equity needed. Banks are also looking more closely at things like any non-business collateral, the experience of the prospective franchisee, and whether or not the household will have a secondary income during the business start-up.

Even this "bad" news has a silver lining. First, it means that franchisees qualifying for credit today are less likely to be at risk if their business performs below expectations as it builds a customer base. Second, credit crunches are typically short term events. In the last year, the Fed has lowered the Fed Funds rate from 5.25% to 1%. Add to that $700 billion of new funds pumped into the nation's banking system and other various relief measures, and most knowledgeable observers will agree that it is not a question of "if" but instead a question of "how soon" will credit start to ease substantially for people looking to invest in small businesses.

Perhaps equally relevant, the tide is likely to turn much more quickly relative to credit than it will for either employment or for renewed confidence in the stock market. Add a dash of pent up demand, and when this happens, the US economy will be poised for a franchise explosion. Whether this boom happens in six months or eighteen months is impossible to say, but savvy franchisors are planning now to capitalize on it.

Of course, the first and most important step is to check the financial health of the core business model. If the franchisor's unit economics are not providing adequate returns in today's market, then affected franchisors would be well-advised to focus on unit level performance. Nothing is more important than a sound economic model

and strong relationships with franchisees. A decline in either will only make it more difficult for the franchisor to expand once credit begins loosening.

For franchisors whose unit economics are still capable of providing an adequate level of return, there are a number of steps that can be taken now that will both improve current franchise sales and position the company for what appears to be a strong market in the second half of 2009.

As a first step, franchisors should re-examine ways in which they can reduce the franchisee's initial investment. Are there ways to reduce initial inventory requirements? Is it time to look at "value engineering" the build-out? Today's down market will likely provide real estate and leasing deals that may never be available again – are there ways to capitalize on those opportunities and promote these deals to their franchisees?

More than ever, franchisors are well-advised to develop relationships with national franchise lenders, if they have not done so already. And, of course, franchisors will want to consider registering on the SBA's Franchise Registry to streamline the lending process. Franchisors may even want to look into ERSOPs and other less conventional funding mechanisms to provide their franchisees with alternatives for financing their investment.

In the short term, franchisors – especially those with higher levels of investment – will need to work harder and get more creative if they hope to hit their franchise sales goals for the first half of 2009. But they should also bear in mind that the drivers of the franchise economy are far different from the drivers of the economy as a whole. Six months from now it is likely that franchising will be leading the economy out of this current downturn, and the franchisors who are preparing for this trend today will reap the harvest then.