CHOOSING A FRANCHISE: HOW BASE FEES AND ROYALTIES RELATE TO THE VALUE OF THE FRANCHISE*

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In recent years, entrepreneurs and "corporate dropouts" or former executives (Fortune 1991) have turned to franchising as an attractive alternative to traditional forms of organization. Franchises such as fast food chains, quick oil change operations, and business support companies (e.g., mail and printing services) have experienced phenomenal growth: an estimated 28,000 new franchise outlets were sold in 1991, compared to 13,960 sold in 1986 (Fortune 1991). There are over 370,000 franchise outlets in the United States, accounting for between $200 billion (Bond 1989) and $700 billion (Fortune 1991) in annual sales.

This growth in franchising has occurred despite the restriction of freedom and financial costs incurred in entering franchise arrangements. Unlike independent entrepreneurs, franchisees must run their businesses as stipulated by the franchisor. Franchise contracts specify the products sold, retail quality standards, prices, and hours of operation. Contracts also specify a starting date, the length of franchise agreements, renewal periods, and termination clauses. More importantly, franchisees do not keep all locally generated profits: they agree to pay franchisors a base fee and ongoing royalties on sales. Contract terms vary greatly, but base fees typically range from $15,000-$40,000 and output royalty payments vary from 3 to 9 percent of gross sales.

"How-to-franchise" resources suggest that the primary reason for this tremendous growth in franchising as an organizational form is that franchisees gain valuable advice, assistance, and a "proven formula" for running a business that increases their chance of success (Bond 1989, Norback and Norback 1982). Entrepreneurs (franchisees) purchase the right to use a franchisor's brand name and are provided with an array of support services that assure the value of the franchise. Contracted services typically include startup assistance such as site selection, lease negotiations, and field training, as well as ongoing services such as central data processing, inventory control, and field operations evaluation (Bond 1989).

In sum, entrepreneurs entering into franchise agreements incur substantial

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restrictions and financial costs. The franchising literature and the rapid proliferation of fast food chains, quick oil change outlets, and similar businesses suggest that the value of the franchise and contracted services are commensurate with fees and royalties charged. We test this notion by examining whether franchisees receive good value for their required fees.

**RESEARCH OBJECTIVES**

Our objective is to assist potential franchisees in determining the value of franchises. We test the proposition that base fees and royalties are positively related and increase with the value of the franchise. We examine whether base fees and royalties demanded by franchisors vary with factors used by potential franchisees as indicators of the value of the franchise (age, growth, and market representation of the franchise operation), and whether they vary with contracted services. In previous studies, researchers have analyzed attitudes about franchising (Knight 1986, Withane 1991), master franchising (Justis and Judd 1986), and perceived advantages of franchising (Peterson and Dant 1990), but they have not empirically addressed how base fees and royalties vary or whether they are related to the value of the franchise. We begin to fill this void in determining the value of franchises.

There are two contributions of our analysis. First, we examine whether franchisees receive good value for their base fees and royalties. If base fees and royalties vary with the value of both the franchise brand name and contracted services, we argue that franchisees receive value commensurate with fees and royalties charged. Second, we examine the usefulness of information provided to potential franchisees in databases such as the *Sourcebook of Franchise Opportunities, 1989* (Bond 1989) for choosing a franchisor. Potential franchisees will view the array of information concerning the value of the franchise and contracted services as useful if it helps them distinguish between franchisors and evaluate the fairness of contracts. Franchisees can make these assessments only if differences exist in indicators of the value of the franchise, if franchisors provide different services, and if value and services correlate with base fees and royalties.

We conclude our analysis with a set of guidelines prospective franchisees can use to determine franchise value and the fairness of base fees and royalties. These guidelines add structure and insight into the time-consuming, tedious, often frustrating, and yet, critical task of choosing a franchisor.

**VALUE OF THE FRANCHISE**

Differences in the value of a franchise affect franchisor-franchisee relationships, beginning with initial contract negotiations. Each franchisor specifies uniform contract terms for all franchisees and these should reflect the value of the franchise and its brand name, estimated financial performance of the retail outlets, and costs associated with providing contracted services. These contract terms are provided in disclosure documents which potential franchisees use to select from the menu of franchise opportunities.

Potential franchisees pick and choose among competing contracts, looking for an opportunity that provides good value and a fairly high probability of success. Unproven franchisors can encounter less demand for their franchise than desired, forcing them to select prospective franchisees solely on the basis of franchisees' financial standing. Franchisors with more valuable name brands and "proven formulas" face greater demand from franchisees and easier entry into new markets. Franchisors with greater value, such as McDonald's, can com-
mand higher fees and royalties and use more stringent criteria for selecting franchisees than less successful franchisors.

Indicators of the Value of the Franchise

We expect base fees and royalties to be associated with factors that potential franchisees use to assess the value of the franchise and future financial performance, such as the age of the franchisor’s operation, degree of market representation of franchise operations, and growth in the total number of retail outlets.

Age of the franchise. In general, the longer a franchise has been in operation, the more secure the franchisee can feel about the likelihood of survival and success. Some corporations, such as McDonald’s, have been offering franchise opportunities since contemporary franchise organizations first appeared, and their continued existence is unquestioned. Other firms seem to view franchising as more of a fad. Many firms have just begun franchising operations or have not established a track record. Their survival and profitability are highly uncertain.

Older, more established firms have longer track records that a franchisee can use to evaluate the possible future performance of the business and the fairness of fees and royalties. A longer track record provides evidence of the franchisor’s ability to weather economic downturns, respond to competitors’ new product introductions, cope with franchisees who experience problems, and so forth. Franchisors who have been in operation longer can demand higher base fees and royalties in franchise contracts. Alternatively, franchisors who began operations fairly recently may not have methods for dealing with competitive challenges, making this a higher risk business for franchisees. As a result, we predict that the value of the franchise, base fees, and royalties will be higher when the franchisor has been in operation for a longer period.

Market representation. Potential franchisees can also assess the value of a franchise based on its representation in state, national, and international markets. The value a franchisor provides to franchisees is closely tied to the recognizability of the name brand and the consistency of products or services across retail outlets. When consumers have good information about prices and quality sold by establishments, national brand names serve as signals that reduce the costs of searching unfamiliar retail markets (Rubin 1978). For instance, many consumers eat at Wendy’s or McDonald’s when visiting a strange city because they know what they can expect, rather than trying to obtain enough information to select from the various unfamiliar restaurants.

Familiarity and value of the franchise likely increase with wider market representation, namely, with the total number of retail units, the number of retail units in each state, and as franchisors expand their operations to more states. “If a company has wide geographic representation and has been able to maintain it for several years, this is an exceptionally strong indication of its ability to develop, market, and support a sustainable program” (Bond 1989, 10).

Growth in retail outlets. Another criterion potential franchisees use to evaluate the value of the franchise and future performance is recent growth (or decline) in the number of the franchisor’s retail outlets. Franchising currently accounts for approximately one third of all retail sales in the United States (Fortune 1991) and this is expected to grow to half of the nation’s sales by the year 2000 (Peterson and Dant 1990).

Despite this growth in franchising in general, some franchisors are expanding, some have stabilized, and others are retrenching operations. For small fran-
Franchisors, growth in retail outlets is tied to providing a quality formula. Larger, established franchisors must maintain the quality of the franchise and service existing franchisee networks to sustain growth. Franchisors experiencing growth have established and continue to maintain the value of their franchise's brand name. Franchisors who exceed managerial capacity (Norton 1988), inadequately police franchisees' operations (Rubin 1978), exceed distribution systems (Weinrauch 1986), or exceed financial resources (Weinrauch 1986) may experience declining numbers of retail units as franchisees select other business opportunities or as some retail outlets fail.

**COSTS OF PROVIDING SERVICES**

Base fees and royalties reflect the value of the franchise and the costs associated with running franchisee operations (Brickley and Dark 1987). Franchisors offering services experience high costs in franchisee operations and pass these costs on to franchisees in the form of higher fees and royalties.

Franchisors vary in the services they provide in franchise contracts, specifying a mix of services that build and maintain the value of the franchise. When franchisees begin operations, franchisors may assist with financing, site selection, lease negotiation, training programs, and store openings. On an ongoing basis, franchisors may provide central data processing, retail unit evaluation, inventory control, newsletters, regional or national meetings, and telephone hotlines. Franchisors use these services to monitor, control, and support franchisees' performance, thus reducing problems in franchisor-franchisee relationships. (These may be intentional or unintentional objectives of franchisors.) Franchisors offering extensive services establish higher base fees and royalties as compensation for the increased costs associated with these monitoring mechanisms.

**METHODS**

**Data and Sample**

We obtained our data on franchise contracts from the *Sourcebook of Franchise Opportunities, 1989* (Bond 1989), a source readily available to potential franchisees. Bond sent questionnaires to all 3,750 franchisors in the United States and 1,050 responded (a 28 percent response rate), furnishing more detailed information than had been provided previously by franchising sources. Each contract represents the standard terms specified by a franchisor in relationships with its franchisees as a group (i.e., each franchisor is represented once in the study) rather than multiple contracts between a single franchisor and its franchisees.

Relationships between base fees, royalties, and our independent variables may vary across industries, so we selected all contracts for U.S. franchisors, charging non-zero base fees and royalties, in three of the largest industries in the *Sourcebook* data set. Our sample includes contracts from 249 franchisors in the fast foods, automotive services, and business services industries, allowing us to examine differences across these industries. Fast food franchisors include 114 firms such as McDonald's, Domino's Pizza, and Arby's, as well as lesser known franchises such as Flooky's and Zipp's. Our 65 automotive services franchisors consist of firms such as Jiffy Lube, Midas, MAACO, and Ziebart, specializing in mufflers, brakes, transmissions, and automobile appearance. In business services, 70 franchisors such as H&R Block, Mailbox, and PIP Printing, offer a variety of services, including accounting, tax consulting, copying or printing, advertising, packaging and mail services, temporary clerical serv-
ìces, general business consulting, and credit agencies.

**Measures of Base Fees and Royalties**

Franchisees pay a one-time base fee for the use of the franchisor's brand name and recurring fees or royalties based on the performance of the retail outlet. Base fees were operationalized in thousands of dollars and output royalties were measured as a percent of sales, as reported in the *Sourcebook of Franchise Opportunities, 1989.*

**Measures of the Value of the Franchise**

Age of the franchise. We measured age of the franchise as the number of years prior to 1989 that the parent corporation had been franchising units.

Market representation. We employed multiple measures of market representation, tapping into three dimensions of this construct. Total number of retail units indicates the visibility of the franchisor's brand name. The largest concentration of retail units in any state and the number of states in which a franchisor operates indicate the regional and national representation of franchise operations within North America.

We did not include a measure of representation in international markets since only a small percentage of franchisors in our sample had international operations and, among those that did, firms like McDonald's (with 2,559 foreign units) skewed the distribution.

Growth of total retail outlets. We calculated growth as change in the total number of retail outlets between 1987-89. *Entrepreneur: Annual Franchise 500* provided data for this measure.

**Measures of Contracted Services**

Contracted services include direct financial assistance such as loans and leases, help with site selection, lease negotiations, and store openings. Franchisors may also provide central data processing, central purchasing, field training, field operations evaluation, inventory control, newsletters, regional or national meetings, telephone hotlines, and cooperative advertising (i.e., franchisors supply materials or pay part of the cost associated with local advertising by franchisees). Franchisors indicated whether they supply these services, and we coded each service as one if provided or zero if not provided. We coded services provided at an additional cost as zero, since they are not included in standard franchise packages purchased for base fees and royalties.

**Size of the Investment**

Base fees and royalties may not reflect differences in the value of the franchise and contracted services, but instead, increase with the size of required investments. There was no theoretical basis for specifying relationships between base fees, royalties, and size of investment, but we included it in our analysis. Franchisees' total investment was measured in thousands of dollars, as reported in the *Sourcebook of Franchise Opportunities, 1989.*

**Data Analysis**

We segmented our sample into firms charging low fees versus those charging high fees in each industry, dividing the groups at the mean for base fees. We analyzed the composition of each group, identifying firms that deviated from the "normal profile" for each group. Some of these firms, such as Hardees or Sonic Pizza, represent exceptionally good value, while others offer extremely poor value relative to firms in the same subsample. We used t-tests to identify significant differences between the means for the value of the franchise and contracted services across industries.

We repeated our analysis for royalties, dividing the sample at the mean for royalties into firms charging low versus high royalties in each industry. Means for base fees and royalties were calcu-
lated independently and firms segmented independently for each measure, so it was possible for firms to be classified as low for base fees and high for royalties, or vice versa; however, our results showed that base fees and royalties were generally positively related, with most franchisors charging either high fees and high royalties or low fees and low royalties.

**RESULTS**

Base fees and royalties related positively across franchisors in all three industries (table 1). The comparison of firms charging low versus high fees revealed that base fees differ significantly and royalties are much higher for firms charging high rather than low fees in all industries. Royalties charged in fast foods firms differ significantly from royalties in the automotive services industry.

Our analysis of firms charging low versus high royalties showed that royalties differ significantly and fees are much higher for high-royalty rather than low-royalty firms in the fast foods and automotive services industries. Business services firms represented the only instance where high royalties are associated with low base fees.

This provides initial support for the notion that both fees and royalties increase with the value of the franchise and expected performance. Franchisors with a successful reputation, "proven formula," and high demand from potential franchisees can charge high base fees and high royalties. On the other hand, franchisors who have difficulty attracting franchisees, have not worked out the problems in running a franchise, or are experiencing trouble coordinating efforts with franchisees demand low base fees and low royalties. Fees and royalties should vary with indicators used by potential franchisees to assess the value of the franchise.

**Indicators of the Value of the Franchise**

Our results in table 1 show that base fees and royalties vary with market representation and age of the franchise, but not with growth in number of retail units. The measures of market representation—total number of retail units, largest concentration in a state, and number of states in which franchisors operate—are significantly different across firms charging high versus low fees and royalties. In general, franchisors charging low fees or royalties have lower visibility, less recognizable name brands, and less representation in markets than firms charging higher fees and royalties. Also, there are significant differences associated with the age of the franchise across groups. Firms charging low base fees and royalties are newer and have less established reputations than firms charging higher fees and royalties, regardless of the industry in which they operate.

Differences in growth in the number of retail units do not relate to base fees and royalties. Indeed, in the fast foods and automotive services industries, rapidly growing firms charge low royalties. We provide a possible explanation for this result in the discussion section.

**Contracted Services**

Startup services offered by franchisors varied across the three industries (table 2). Few firms in the fast foods industry provide financial assistance such as loans and leases to franchisees. A slightly higher percentage of firms in the automotive services industry supply this service, while approximately 30 percent of business service franchisors offer financial assistance. Regarding the other startup services, the fast foods and automotive service industries have the highest percentages of firms assisting in site selection, lease negotiations, field training, and store openings. Business service
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* Statistically significant difference between Low and High groups at the .10 level.

* Mean values are shown for all variables except sample size. Base fees are in thousands of dollars, and royalties represent the percentage of a franchisee's annual sales.

* Fast foods franchises charging low base fees have 28.9 units on average, significantly fewer than the average 420 retail outlets of fast foods franchises demanding high base fees.
### Table 2
PERCENTAGE OF FIRMS PROVIDING STARTUP AND ON-GOING SERVICES, BY BASE FEES AND ROYALTIES

|                      | Fast Foods | | Automotive Services | | Business Services | |
|----------------------|------------|----------------|------------------|------------------|--------------------|
|                      | Base Fees  | Royalties     | Base Fees        | Royalties        | Base Fees          | Royalties          |
|                      | Low        | High          | Low              | High             | Low                | High               |
| **Startup Services:**|            |                |                  |                  |                    |                    |
| Financial Assistance | 3.8        | 2.2           | 4.0              | 4.2              | 11.5               | 9.1                |
| Site Selection       | 96.2       | 95.7          | 96.0             | 93.8             | 73.1               | 93.9*              |
| Lease Negotiations   | 83.0       | 87.0          | 80.0             | 89.6             | 76.9               | 84.9               |
| Field Training       | 90.4       | 93.5          | 88.0             | 89.4             | 88.5               | 93.9               |
| Store Openings       | 90.4       | 93.5          | 66.0             | 70.2             | 80.8               | 97.0*              |
| **Ongoing Services:**|            |                |                  |                  |                    |                    |
| Cooperative Advertising | 71.7      | 76.1          | 72.0             | 77.1             | 73.1               | 78.8               |
| Central Data Processing | 9.6      | 10.9          | 10.0             | 8.5              | 15.4               | 18.2               |
| Central Purchasing   | 59.6       | 67.4          | 54.0             | 66.0             | 57.7               | 54.6               |
| Retail Unit Evaluation | 96.2     | 97.8          | 96.0             | 95.7             | 84.6               | 97.0*              |
| Inventory Control    | 71.1       | 60.9          | 88.0             | 93.6             | 50.0               | 63.6               |
| Newsletters          | 78.9       | 82.6          | 82.0             | 80.9             | 84.6               | 90.9               |
| Reg'l/Nat'l Meetings | 59.6       | 69.6          | 58.0             | 72.3             | 84.6               | 75.8               |
| Telephone Hotline    | 57.7       | 54.4          | 58.0             | 61.7             | 76.9               | 81.8               |
| **Other Factor:**    |            |                |                  |                  |                    |                    |
| Total Investment ($000) | 230.8   | 325.6         | 290.6            | 249.3            | 119.1              | 213.5*             |
|                      |            |                |                  |                  |                    | 190.4              |
|                      |            |                |                  |                  |                    | 145.7              |
|                      |            |                |                  |                  |                    | 61.1               |
|                      |            |                |                  |                  |                    | 88.6*              |
|                      |            |                |                  |                  |                    | 72.8               |
|                      |            |                |                  |                  |                    | 76.8               |

* Statistically significant difference between Low and High groups at the .10 level.
firms are less likely to provide startup assistance.

Additionally, the ongoing services offered by franchisors varied widely across industries (table 2). Two characteristics are common to all three industries: most franchisors engage in retail unit evaluations and few franchisors offer central data processing services. Beyond this, differences between industries seem to reflect the types of products or services sold. In the fast foods and automotive services industries, the majority of firms provide cooperative advertising and inventory control, services consistent with selling high-volume products in consumer markets. In the automotive and business service industries, most firms provide newsletters, regional or national meetings, and telephone hotlines, possibly because their products or services (automobile repair or business advice) are more sophisticated, technologies change constantly, and franchisees confront a greater number of problems for which they are unprepared.

Within industries there is less variability in services provided across the groups: firms charging high versus low base fees and royalties offer fairly similar services. In the fast foods industry, the percentage of firms reporting that they provide each of the startup and ongoing services does not vary significantly. Few firms offer financial assistance and central data processing, while most firms provide assistance with site selection, training, store openings, and retail unit evaluation. In the fast foods industry, the percentage of firms providing particular startup and ongoing services appears to be independent of whether they charge high or low base fees and royalties.

In automotive services, franchisors charging higher base fees are more likely to provide assistance with site selection, store openings, and retail unit evaluation. Firms charging higher royalties are more likely to provide central data processing and inventory control. No statistically significant differences exist in the percentages of franchisors providing other types of startup and ongoing services.

In the business services industry, franchisors charging high base fees are more likely to offer assistance with retail unit evaluation. No other statistically significant differences in startup and ongoing services exist to explain variations in base fees. Firms charging high royalties are more likely to provide financial assistance but are less likely to provide help with site selection, lease negotiations, store openings, and inventory control. The percentages of high-royalty firms supplying assistance with field training, cooperative advertising, central data processing, central purchasing, and that have newsletters are lower than for low-royalty firms, but differences are not statistically significant. Our results suggest that royalties may be linked to factors other than contracted services in the business services industry.

Finally, higher base fees relate positively to differences in franchisees’ total investments in all three industries. Differences in total investment are statistically significant in the automotive services and business services industries, indicating that fees may partly reflect financial considerations rather than the value of the franchise or contracted services.

DISCUSSION

Our results allow us to draw several conclusions about relationships between base fees, royalties, value of the franchise, and contracted services. These relationships have important implications for potential franchisees.
Indicators of the Value of the Franchise

Base fees relate positively to royalties in all three industries, suggesting that the value of the franchise is important in a variety of franchising opportunities and is reflected in higher base and royalty fees. Potential franchisees may be mistaken in believing that they can reduce ongoing royalties by paying a higher base fee.

Additionally, our results indicate that base fees and royalties relate strongly to indicators that potential franchisees use to assess the value of the franchise. Older franchisors with wider market representation demand higher fees and royalties than newer franchisors with less extensive operations. Name recognition is critical in franchising, so more visible firms have high value and establish high fees and royalties. Age of the franchise may be an especially important predictor of base fees and royalties in the business services industry, an industry in which longevity and reputation are highly valued. Many firms in this industry provide advice or financial consultation, making stability over time a critical aspect of the value of the franchise.

Growth does not predict base fees or royalties. This may be because some franchisors reduce base fees and royalties to pursue growth. Alternatively, franchisees may associate growth with instability or unanticipated outcomes, such as unkept promises, raw materials distribution problems, cash flow shortages, and inconsistent quality. Rather than a positive signal, growth may be a danger signal or indicator of increased risk for potential franchisees.

Contracted Services

Contracted services vary more across than within industries, making them less useful predictors of base fees and royalties. An important difference between the fast foods and automotive services industries versus the business services industry is that startup activities, such as new store openings, contribute to the value of the franchise and higher fees and royalties in the high-volume, consumer markets. Startup services appear to be of less value in markets populated by professional business men and women. A difference between the fast food industry versus the automotive and business services industries was that, in technology-based markets, services such as regional or national meetings and communication networks (e.g., telephone hotlines) are critical resources provided to franchisees.

Some ongoing services are undesirable in the business services industry. Extensive system support services such as field training, cooperative advertising, central data processing, and central purchasing are not valued by franchisees in this industry, so they are associated with low royalties. Trained, professional business people simply wanting to purchase the brand name, or franchisees purchasing the brand name and formula in order to operate "stand alone" businesses (e.g., PIP Printing), may view ongoing support systems by franchisors as intrusive or, at best, of little value.

GUIDELINES FOR DETERMINING FRANCHISE VALUE

What do our results mean for potential franchisees? We offer five guidelines which potential franchisees can use to determine franchise value. These guidelines reflect our empirical results so they may have greater validity than those offered in "how-to-franchise" resources. We do not venture beyond guidelines justified by our empirical results, so our guidelines do not represent a comprehensive or exhaustive list.

Franchisees: You Get What You Pay For

Fees and royalties relate positively to the value of the franchise in the three
industries examined. This suggests that, as a general rule, franchisees get value comparable to fees and royalties paid. The market for franchise opportunities, or competition between franchisors, establishes fair prices. We believe this market works best for well-known names for which new franchise units are frequently sold. The market for less familiar franchises is thinner, with fewer franchise units sold, and franchise value less firmly established, so base fees and royalties may not reflect fair market value.

Franchisees pay for value that is reflected in differences in franchisors' base fees and royalties, making these fair prices. Potential franchisees desire exceptional franchise opportunities where base fees and royalties are low relative to the value provided, but identifying situations where value provided exceeds fees can be challenging.

Exceptional franchise values exist, and franchisees can identify them by comparing the target franchise's fees, royalties, age of operation, and market representation against average values on those factors for the industry. For instance, Hardees Incorporated, which has been operating for 26 years, has 3,038 outlets spread across 38 states; 334 outlets are concentrated in one state. This compares favorably with the mean values for firms charging high base fees in the fast foods industry (shown in table 1). Firms with high base fees have, on average, been in operation for 11 years, with 420 outlets which are spread across approximately 13 states, and they have 52 outlets concentrated in a single state. Yet, Hardees Incorporated charges $15,000 in base fees and 3.5 percent of sales as royalties. These fees are consistent with firms in the low base fees group, who charge an average of $12,200 in base fees and 3.9 percent of sales in royalties, versus firms in the high base fee group who demand $24,100 in base fees and 4.7 percent of sales in royalties (table 1). Franchisees selecting Hardees Incorporated pay fees and royalties comparable to those in the low fees and royalties group but gain experience, reputation, and market representation consistent with firms charging much higher fees and royalties.

Similar comparisons in the automotive and business services industries can help franchisees locate franchises offering exceptional value. Speedy Muffler, an automotive franchisor, has only been in existence for three years, but already has 355 units in 14 states, with 37 units concentrated in a single state. Yet, Speedy Muffler demands an $18,500 base fee and 5 percent royalties, amounts much lower than franchisors in the high fees and royalties group.

In the business services industry, Mailbox represents another example of exceptional value. Mailbox has been franchising for nine years, expanding operations into 46 states, with 753 total units and 175 units concentrated in a single state. These statistics exceed the average values for business services franchisors charging high fees and royalties, but Mailbox only charges franchisees $19,500 in base fees and 5 percent in royalties. Franchisees comparing these fees and royalties against the average values of $27,600 in base fees and 7.1 percent in royalties charged by franchisors in the high fee and royalty group should recognize Mailbox as an exceptional value in the business services industry.

Franchisees can insure that they get what they pay for by comparing a potential franchise against average values for that industry. Exceptional values exist, but this type of analysis can also reveal poor franchising values. If base fees and royalties seem to be too good to be true, franchisees should beware. Franchisors
charging zero royalties may not provide long-term support, and franchisors charging zero base fees may organize independent retailers into a distribution network, rather than provide a proven business formula. New franchises, with limited market presence, may have potential and the idea of getting in on the ground floor may be attractive; however, small franchisors sometimes fail, offer unproven formulas, may present numerous operating problems, and should offer lower fees and royalties. Franchisees should also watch for more established franchisors who intentionally or unintentionally charge inflated base fees and royalties.

Use Market Representation and Age as Indicators of Franchise Value

Base fees and royalties relate positively to indicators of the value of the franchise: age, number of retail units, concentration in the state, and national representation. Based on these results, we conclude that wider market representation and longer franchisor reputations provide value for franchisees.

Prospective franchisees can use these attributes to evaluate franchise value and the fairness of fees and royalties, consulting databases like the Sourcebook of Franchise Opportunities, 1989 for this information. We encourage potential franchisees to plot or statistically analyze relationships between base fees (or royalties), age, number of retail units, concentration in states, and national representation to determine fair value: whether base fees are justified by the longevity of a franchise or its market representation.

Our examples of Hardees, Speedy Muffler, and Mailbox illustrate the importance of analyzing these relationships. These firms charge low to moderate fees and royalties, and offer greater market representation than most firms in their respective industries, since they have more total units, higher concentration in a single state, and operate in more states than their competitors. Speedy Muffler illustrates the importance of statistically analyzing multiple variables since the age of their operation is much lower than the average for their industry. Market representation and other factors offset the disadvantage of a fairly short track record, but franchisees might miss this fact unless they conduct a careful analysis.

Indicators of the value of the franchise may be most useful in identifying exceptions to the rule: extremely good or bad franchising values. By plotting relationships between base fees (or royalties), age, total retail units, concentration in the state, and national representation, potential franchisees can avoid the mistake of finding out after signing a contract that a competing franchise with a longer track record and wider market representation, and therefore, a stronger brand name, charges a 5 percent royalty versus the 8 percent of gross sales to which they are legally bound.

Information on Contracted Services (Reported Yes/No) Is Not Useful

Few differences exist between firms offering startup and ongoing services in the fast foods industry. Fast food franchisors typically do not provide services such as financial assistance and central data processing and virtually all firms supply services such as site selection, training, store openings, and retail unit evaluation. Also, startup and ongoing services appear to be independent of whether franchisors charge high or low base fees and royalties.

The absence of significant relationships in automotive services and negative relationships between many services, fees, and royalties in business services may leave many potential franchisees dismayed and confused. In the
automotive services industry, a few startup and ongoing services distinguish between franchisors, but there are no statistically significant differences in the percentages of firms providing most types of services.

In the business services industry, franchisors charging higher royalties are less likely to assist with site selection, lease negotiations, store openings, inventory control, field training, cooperative advertising, central data processing, and central purchasing than those demanding lower royalties, but some of these relationships are not statistically significant. Since business service firms charge the highest ongoing royalties in our sample, potential franchisees may wonder about the equity of royalties and whether they get something in return. Our analysis suggests these franchisees may be getting greater value in terms of the brand name and longevity of the organization, but they do not receive more services.

We believe relationships between services, base fees, and royalties may make less sense and be less apparent when potential franchisees use less sophisticated analyses. Some franchisors provide services for additional fees, further complicating the potential franchisee's task of determining fair value. (We excluded services provided for additional fees from our analysis.) We conclude that information concerning contracted services (reported yes, no, or available for additional fees) provides little useful information for delineating franchisors.

Identify Critical Services In Your Industry

Critical services vary across industries and franchisees must identify the critical services that create and maintain trademark value in their particular industry. Franchisors do not need to offer all services and should not try to duplicate the package of services offered by rivals. As we noted earlier, potential franchisees may make poor decisions by selecting a franchisor based on the number of services provided, since they may receive unneeded services and pay unnecessarily high fees and royalties.

In high-volume consumer markets, such as fast foods and automotive services, store openings and other marketing-related activities contribute to the value of the franchise. Startup services offer less value in markets populated by professional business men and women. In technology-based markets, like automotive and business services, regional or national meetings and communication networks (telephone hotlines) represent critical resources provided to franchisees. Extensive system support services such as field training, cooperative advertising, central data processing, and central purchasing are not valued services in the business services industry.

Potential franchisees should be selective and carefully identify critical services that create and maintain franchise value in their particular industry. They can then choose a franchisor providing these services at competitive prices.

Determine the Quality of Services

Franchisees should realize that the value they receive reflects not only the age of the franchise and width of market representation but also the quality of services made available to franchisees, the means of assuring quality in franchises throughout the system, the effectiveness of corporate marketing, and the overall management skills level. When someone considers purchasing a franchise, multiple factors determine the value of the franchise.

Indicators of contracted services (coded 1 if provided and 0 if not provided) do not capture the quality of assistance provided by franchisors. A franchisor
may provide a very limited number of high quality services, contributing significantly to the success of franchise outlets, or could provide extensive services which offer little assistance to franchisees. Franchisors, reporting they assist with site selection, could conduct market analyses, study traffic flows throughout the day, forecast trends in local economic development, or present a list of suggested guidelines to franchisees. They could chaperon franchisees through the process of securing a loan with favorable rates, or alternatively, could supply a list of lending institutions in the franchisee's geographic area.

Information on the quality of individual services is not available in databases such as the Sourcebook of Franchise Opportunities, 1989 and may not be available in disclosure documents from franchisors. Potential franchisees need to do their homework, obtaining this information through interviews with established franchisees.

REFERENCES
Fortune (1991), "Corporate Dropouts Go. Franchising" (August 26), 12.

SMALL BUSINESS HOTLINE

The Export-Import Bank has instituted a toll-free Small Business hotline: 800/424-5201. This is a specialized service for smaller exporters needing both general information and problem-solving assistance in conducting business overseas. It provides information on export credit, available assistance from other government agencies and certain private sector sources.