

What's So Great About a Franchise?

By Dan Brunell January 2010

In the course of my business, I am often asked “When I buy a franchise, what do I get for my money?” The short answer is “a business model.” A business model is a framework for creating economic value; in other words, it's a system for making money.

Many first time entrepreneurs confuse the investment in a franchise as a purchase of physical property, when what a franchise represents is intellectual property. The capital equipment, inventory, furnishings, fixtures or the cost of building out the location is part of any business be it franchised or not. The real value in a franchise is that you get a fully formed, proven business model. An effective business model is the difference between success and failure in a business.

The old maxim that most businesses fail because they are under capitalized is rubbish. Most of these businesses wouldn't have been considered under capitalized if they would have had an adequate business plan. Every year thousands of well capitalized startups with brilliant ideas for a product or service fail. This not for lack of money; it is because they *eventually* burn up all of their cash while trying to develop a system for delivering their product into the hands of a paying customer. All business models are initially perfected by trial and error – this is a very costly process that most small businesses cannot afford to live through. That is why so many private startups fail where franchises succeed.

The costs associated with perfecting a business model will almost always eclipse the cost of paying a franchise fee. The average franchise fee is about 25k. Most starts up waste more than that in advertising costs alone while they experiment with different marketing strategies. The advantages of having the learning and cost curves reduced to a fraction of the “learn as you go” method are very significant, to say the least.

The other cost component of a franchise is the royalty. This is a fee paid for on-going support which of course includes continuous improvement of the business model, access to vendor discounts, product R&D, marketing and advertising programs, etc. Typical support royalties are between 6% and 8% of revenue. This fee usually pays for itself due to the savings realized when the franchisee purchases goods and services for the business at below market, national account rates. Additionally, most franchisees will experience much higher sales than they would as a private company – greatly in excess of 8% higher - because of the franchisor's well designed marketing strategy.

A franchise may not be right for everyone and they are certainly not all created equal, but a good business model can lower the risk factor and accelerate one's potential for long term success. As always, the key is finding the right match between the model and the operator.

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