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FRANCHISE INCENTIVES



Charlie Rakowsky bought a 360° Painting franchise in San Antonio.

With tight lending, some franchisors loosen restrictions for buying into business

CATHERINE DOMINGUEZ / SAN ANTONIO BUSINESS JOURNAL

BY RANDY LANKFORD

While no one is likely to describe the current unemployment rate of nearly 10 percent as good news, there are those who are able to find a silver lining in today's tough job market. Companies looking for high-quality franchisees see it as an opportunity.

"We saw a lot of people inquiring about the franchise system in 2008 and 2009 because of the high unemployment rate," explains Paul Flick, CEO of Home Service Franchising. "They may have gotten downsized out of the corporate world or stuck in a job with no chance of promotion because of the downturn in the economy."

Yet, the credit crunch has made it tougher for some with great entrepreneurial drive to get a franchise business off the ground.

"The equity in their home or stock account might have been down 30 or 40 percent but they still had great credit ratings and were passionate about getting into their own business," Flick says. "So we were seeing great clientele out there and we could either turn them away because they didn't have the liquidity or we could bring them in under favorable terms."

So Flick did what a growing number of franchisors are doing: He lowered the barrier to entry to his company. Home Service Franchising, which franchises 360° Painting, a residential and commercial painting service, reduced its franchise fee from \$40,000 to \$30,000. And, perhaps even more significantly in a tight lending market, it began financing up to 50 percent of that franchise fee.

"They still have to put some skin in the game," says Flick. "But we obviously get great talent during some tough economic times."

The credit crunch is an issue facing the franchising industry as a whole. Last December, the International Franchise Association predicted a \$3.4 billion shortfall in lending to franchise businesses.

"Our data show that while there will be sufficient capital for franchise development in 2010, banks' continued risk aversion is limiting their willingness to lend," IFA President & CEO Matthew Shay said at the time.

New ideas

Alisa Harrison, a spokeswoman for IFA, says the credit crunch has led the organization and its members to tackle the issue of financing on several fronts. For one, the organization is lobbying Congress to change the SBA lending limit from \$2 million to \$5 million, a move that the group believes would allow existing franchisees to acquire more capital-intensive units and further expansion.

Until recently, she says, many IFA members had long-term borrowing relationships with lenders and did not have the need for SBA loans. However, with the credit crunch, many borrowers have found

the SBA to be another source, and raising the lending limit would allow borrowers of more capital intensive franchises — such as hotels — access to funding.

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Charlie Rakowsky
360° Painting

All the group's members, she says, are seeking ways they can get franchisees in business, depending on the size and category. "Every company is looking into how they can make it easier for people to buy their franchise," she says. "A lot of our members have gone into self-financing, or back-ending upfront costs."

That was the case for Charlie Rakowsky, 52, who bought a 360° Painting franchise in San Antonio through Home Service Franchising at a discount with partial owner financing.

Rakowsky says he bought into the com-

pany as a way to develop a business he can hand down from one generation to the next.

"A tough economy is not necessarily a bad thing for a franchisee," he says. "When the population is fully employed there aren't a lot of people considering franchising. During tough economic times, there may be more people thinking, 'I need to find an alternative to what I'm doing now.'"

"This is my second career. I was a vice president for a food company," he continues. "As I got older I was looking for a business I could operate either full time or part time and maybe someday hand over to my daughter."

At the other end of his career is Brandon Burgoon, 24, a recent graduate of Texas A&M who will soon open his Pita Pit franchise near the Sam Houston State University campus in Huntsville. The cost of entry into the business was a deciding factor for the young entrepreneur.

"I looked at every (quick-service restaurant) franchise opportunity that exists, Subway, McDonald's, Burger King. Those require an initial investment of something like \$3 million. Pita Pit is more like a quarter million. That's much more feasible in my situation."

Oxford, Ohio-based Pita Pit, which has 170 locations, has reduced its franchise fee from \$25,000 to \$20,000 for new franchisees like Burgoon and is encouraging its existing franchise owners to open additional locations by lowering their franchise fee to \$15,000. The corporation has also reduced its monthly royalties from the industry-standard 6 percent of sales to 4 percent for existing franchisees for the first

See FRANCHISING, Page 26

FRANCHISE BUSINESS ECONOMIC OUTLOOK, 2007-2010

	2007	2008	2009	2010	Average annual % change	
					2007/2009	2009/2010
Establishments	847,244	883,984	883,292	901,093	-0.1%	2.0%
Employment (Thousands)	9,859	9,931	9,522	9,558	-4.1%	0.4%
Output (Billion of dollars)	\$802.9	\$850.4	\$844.7	\$868.3	-0.7%	2.8%

Source: PricewaterhouseCoopers

FRANCHISING: Companies discounting fees, royalties to attract buyers of new units

FROM PAGE 19

year and 5 percent for the remainder of the standard 10-year contract.

"The economy was the main driving force behind why we decided to offer these discounts," explains Corey Bowen, Pita Pit vice president of franchise development. "We wanted to reduce the barrier to entry so to speak. So to lower the initial fees and offer more competitive royalties made sense for more people."

Huddle House is another restaurant franchisor seeking to expand in a tough market. A family-style diner chain founded in Decatur, Ga., in 1965 and now headquartered in Atlanta, it is interested in small markets, where its business model of relatively small stores with low-cost menus is most likely to succeed. Chief Development Officer Thomas Flaherty says the company's strategy is to grow the brand by helping franchisees get off to a good start.

"We've lowered our franchise fee from \$25,000 to \$5,000 and while that's certainly significant, we've also deferred our royalties for the first five months of operations. So for the first five months a new restaurant is open, they pay absolutely no royalties."

"We encourage them to use that money for marketing in the early stages. We want every franchisee to get off to a good, strong start and that's a good way to do it."

Flaherty, who spent 13 years in franchise development with pizza chain Papa John



Flaherty

International, says the relatively low cost of entry for a Huddle House restaurant is a far cry from some other food service franchises.

"When you start talking about the larger brands like Denny's or IHOP, those restaurants can cost anywhere from \$1 million to \$4 million (annually) to operate. That shuts out a significant number of people interested in opening a restaurant. And even though Huddle House is a full service restaurant, the sites range from about 1,800 to 2,200 square feet and that can accommodate about 60 to 80 seats. So a lot of our franchisees buy the land and the building and they are able to own their entire operation. Some others lease their property and that makes a Huddle House more obtainable for a lot of people."

Steve Bitonti opened his first Huddle House in Lockhart, Texas, in 2009. The cost of the franchise and the small town atmosphere were two of the factors he considered when choosing a brand.

"I grew up in a small town back East and Lockhart reminded me of that. It's got its little quirks and I like the atmosphere. Everyone I spoke to here gave me a good feeling, he says. "That's kind of Huddle House's niche, going into these smaller communities that don't have a lot of restaurants. I looked at a lot of franchise opportunities and this seemed to be the best fit for me because the building's half the size of a Denny's or an IHOP and there's not so much cost involved when you're buying the land and building the building. I wasn't trying to cut corners, but I needed to see something that was going to be a good fit for me and a good fit for the community."

Flaherty adds Huddle House is also encouraging its franchisees to open more than one location. "If you wanted to build three stores in San Antonio today, you could sign up under this development incentive program and, even if you don't open your third store for three years, you would still only pay \$5,000 for that franchise. We're trying to help that multi-unit operator so that's given a lot of existing franchisees the opportunity and idea to build more restaurants which is good for everyone."

Limiting discounts

Not all franchisors are making concessions, however, particularly in the case of well-established brands.

Take McDonald's. With more than 13,000 franchises in the United States, it is one of the most recognized, and sought after, brands in the world. Lita Salazar currently owns two of the restaurants in San Antonio, one in Spring Branch and would like to have more.

"There's a waiting list to get a McDonald's franchise," the Laredo native explains. "My husband and I opened our first restaurant in Rockport in 1995 and then another one in Aransas Pass in 1997. When an owner/operator here in San Antonio decided to retire, we sold those two franchises and bought the ones he had here."

"We're definitely looking for more opportunities but those are few and far between," Salazar continues. "When McDonald's decides to add more restaurants to the market the operators already in the community will apply and then you also have the new franchisees wanting to enter the market applying as well. Then McDonald's decides who will get to open a restaurant."

Fantastic Sams is another well-established franchise network. It operates 25 salons in the San Antonio area. Those franchises were set up by the Massachusetts-based company, which charges \$25,000 to \$30,000 for its franchise fee, depending on the location.

Scott Colabuono, CEO and president of Fantastic Sams Hair International, says the company hooks up well-vetted applicants with third-party lenders, but he doubts discounts make a difference in attracting interest. "If someone is considering going into a franchise (relationship), do you

really think that an incentive of \$5,000 (20 percent fee reduction) is going to make a difference?" he says. "Nobody makes a lifestyle change because of a discount."

That said, he admits one of the company's developers, which signs up franchises outside of the company's own six regions, is discounting the franchise fee for the Denver region.

"In the Denver market, they're running a discount to see if it brings in any new business," he says. The franchise fee for that area is currently \$20,000. "We're watching Denver closely to see if it does have an effect."

In addition, the company offers a 20 percent discount through the International Franchise Association's Veteran's Transition Initiative, or VetFran program, which is designed to help honorably discharged military veterans segue into civilian life. The program also includes \$5,000 in the company's private label hair products free before opening.

Colabuono notes that the hair salon franchise does not charge royalty fees based on its stores' gross revenues; instead, a flat fee is charged, allowing franchisees to keep more of the revenue they earn from improving their business. While the fee can vary depending on the region and run as high as \$18,000 annually, Colabuono contends it is more competitive than the traditional royalty structure. Fantastic Sams currently has 1,280 stores nationwide.

Cecil Schenker, a San Antonio-based corporate attorney specializing in business transactions with the Cox Smith law firm, says while the trend among franchisors of reducing entry fees and lowering or deferring royalties is a good way to grow a brand, it should be used carefully by both companies and potential franchisees.

"If I'm representing the franchisee, I want to have that heart-to-heart conversation where I ask them, 'Are you sure can afford this?' and 'Are you really qualified to run your own business?'" he says. "And if I'm representing the franchisor, I want to ask them the same type of questions to make sure they're not going to grant a franchise to someone who's likely to fail and leave them with an empty store, making it just that much harder to get back into the marketplace."



Colabuono



Salazar