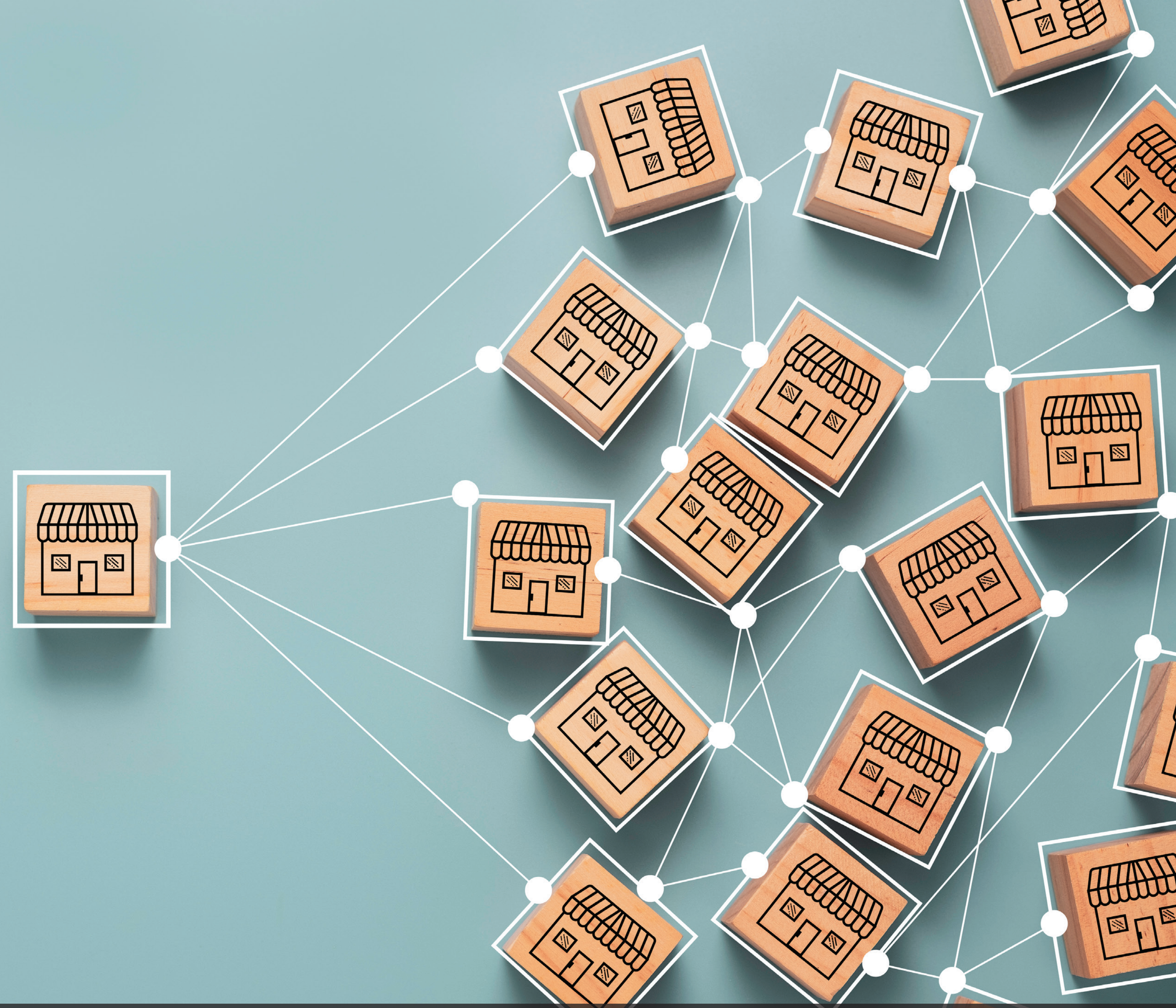

Vertical Market Outlook Series

Franchise

EQUIPMENT LEASING & FINANCE
FOUNDATION
Your Eye on the Future

Established in 1989, the Equipment Leasing & Finance Foundation is a 501c3 non-profit organization dedicated to inspiring thoughtful innovation and contributing to the betterment of the equipment leasing and finance industry. The Foundation accomplishes its mission through development of future-focused studies and reports identifying critical issues that could impact the industry.

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Purpose of This Study

The Equipment Leasing & Finance Foundation (Foundation) commissioned this forward-looking report on the franchise sector. Big Village was selected to conduct the research. This, the eighth in a series of reports on vertical equipment markets, provides an outlook on the franchise sector in the U.S., including trends and key developments impacting this sector over the next one to two years. In preparing this report, Big Village utilized its pre-existing expertise, coupled with inputs from several outside industry experts and consultants, in analyzing and examining industry trends in the U.S.

How to Use This Report

This report is intended to provoke thought, conversation, and offer high-level insight for equipment finance professionals to reference in strategic planning. There are many subcategories within franchises. This report focuses on those most relevant to the equipment finance sector, as determined by a Foundation-led Steering Committee of industry professionals.

The Franchise Market Landscape

The beginnings of franchising can be traced back to the Middle Ages "when landowners made franchise-like agreements with tax collectors, who retained a percentage of the money they collected and turned the rest over." Currently, in the United States, franchises contribute "more than $500 billion in GDP (3 percent of total GDP)"[1] and appear in just about every industry sector

Definition and Composition

Franchises and franchising are often defined in terms that describe the relationship between the franchisee and the franchisor. The International Franchise Association (IFA), a key trade organization for this segment, provides the following definition:

> *"A franchise (or franchising) is a method of distributing products or services involving a franchisor, who establishes the brand's trademark or trade name and a business system, and a franchisee, who pays a royalty and often an initial fee for the right to do business under the franchisor's name and system. Technically, the contract binding the two parties is the "franchise," but that term more commonly refers to the actual business that the franchisee operates. The practice of creating and distributing the brand and franchise system is most often referred to as franchising."*[2]

Definition by Type

The franchise sector can be defined and measured in a variety of ways. The IFA identifies two kinds of franchising relationships. Business Format Franchising is the most identifiable type according to the IFA. In this model, the franchisor provides to the franchisee "not just its trade name, products, and services, but an entire system for operating the business. The franchisee generally receives site selection and development support, operating manuals, training, brand standards, quality control, a marketing strategy, and business advisory support from the franchisor." Traditional or product distribution

franchising is the larger type of franchise and includes such examples as bottling, gasoline, automotive, and other manufacturing industries.[3]

Alternatively, according to Forbes, the franchising market can be segmented as follows:[4]

1. **Job-Franchise:** A franchise model that is designed to be owned and run by one person or with minimal additional staff. The name derives from the fact that the franchisee is creating a job and income for themselves by buying the franchise. The franchisee delivers services or sells products to their customer base. Examples of a job franchise would be cleaning services or lawn care.
2. **Investment Franchise:** A larger operation, requiring significant capital expenditure. In most cases, the franchisee will not be involved in the business on a day-to-day basis. Additionally, the franchise will require a significant professional management team to operate it. The franchise is likely to be a corporate investor and to have significant commercial experience in the same or similar sector. Examples include hotels, large restaurant franchises, as well as some retail franchises and gym brands.

3. **Distribution Franchise:** The franchisor grants the franchisee the right to distribute or sell their product or range of products to customers. A distribution franchise differs from other types of franchises because generally the franchisee will operate and sell the franchisor's product under their own identity instead of adopting the franchisor's name and operational systems. Examples include car dealerships and electrical appliance retailers.
4. **Business Format Franchise:** The franchisor provides the franchisee with everything needed to set up and operate the business, from equipment and premises if required, to training, operational systems, supplier contracts, marketing tools and support, and more. The business format franchise can appear in a variety of industries, from fast-food restaurants and coffee shops to business services and personal care.
5. **Conversion Franchise:** The franchisee joins the franchisor's network already owning an independent business within the franchisor's industry. The existing entity is converted into a franchise branch, which allows a franchisor to quickly expand a network and offers the franchisee the benefits of becoming part of a well-known brand. Conversion franchises are common within the real estate industry, dental and medical clinics, and hairdressing.

Micro franchises offer an opportunity for those seeking small-scale entry into the franchise segment. Micro franchises have "all of the attributes of a traditional franchise business model, but with a smaller operation that can be mobile-or home-based." They commonly require a much lower investment and "can be perfect for first-time franchise buyers and budding entrepreneurs alike" as well as younger franchisees. Micro franchises can be found in such industries as "residential and commercial cleaning, kiosk-based retail operations, dog-walking, and pet-sitting."[5] Entrepreneur reports that private equity firms and companies in adjacent markets have been investing in firms that provide micro franchise opportunities.[6]

Definition by Industry

The IFA segments the franchise market by the following business lines:

- Business Services (i.e., IT services, broker services, advertising services, mailing, packing, and shipping)
- Commercial and Residential Services
- Lodging
- Personal Services (i.e., fitness centers, spa, and massage centers, beauty-related studios)
- Quick Service Restaurants
- Real Estate
- Retail Food, Products & Services
- Table/Full-Service Restaurants

According to IFA data published in March 2023, quick service restaurants will be the largest segment in terms of the number of establishments in 2023, with personal services and QSR having the strongest growth over the previous year[7].

	2016	2017	2018	2019	2020	2021	2022	2023 (proj.)
Business Services	108,172	108,813 (+0.6%)	103,886 (-4.5%)	102,645 (-1.2%)	97,732 (-4.8%)	99,296 (+1.6%)	100,533 (+1.2%)	102,343 (+1.8%)
Commercial & Residential Services	65,114	66,041 (+1.4%)	66,495 (+0.7%)	67,226 (+1.1%)	73,116 (+8.8%)	75,678 (+3.5%)	77,850 (+2.9%)	79,485 (+2.1%)
Lodging	27,450	28,374 (+3.4%)	33,240 (+17%)	33,997 (+2.3%)	34,455 (+1.3%)	35,041 (+1.7%)	35,566 (+1.5%)	35,833 (+0.8%)
Personal Services	105,147	109,898 (+4.5%)	114,058 (+3.8%)	118,825 (+4.2%)	110,050 (-7.4%)	114,012 (+3.6%)	117,368 (+2.9%)	120,302 (+2.5%)
Quick Service Restaurants	191,395	192,992 (+0.8%)	194,395 (+0.7%)	196,794 (+1.2%)	183,543 (-6.7%)	188,402 (+2.6%)	192,057 (+1.9%)	196,858 (+2.5%)
Real Estate	61,313	63,098 (+2.9%)	64,170 (+1.7%)	65,307 (+1.8%)	66,332 (+1.6%)	67,929 (+2.4%)	68,603 (+1.0%	68,260 (-0.5%)
Retail Food, Products & Services	144,516	146,622 (+1.5%)	151,390 (+3.3%)	155,649 (+2.8%)	157,538 (+1.2%)	162,579 (+3.2%)	165,636 (+1.9%)	169,114 (+2.1%)
Table/Full Service Restaurants	32,740	32,914 (+0.5%)	32,843 (-0.2%)	33,160 (+1.0%)	31,004 (-6.5%)	32,027 (+3.3%)	32,879 (+2.7%)	33,240 (+1.1%)
Total	735,847	748,752 (+1.8%)	760,476 (+1.6%)	773,603 (+1.7%)	753,770 (-2.6%)	774,965 (+2.8%)	790,492 (+2.0%)	805,436 (+1.9%)

Chart Data Source: IFA

Looking at the franchise market in terms of employee data, quick-serve restaurants are by far the largest category:

	2016	2017	2018	2019	2020	2021	2022	2023 (proj.)
Business Services	644,802	651,659 (+1.1%)	629,027 (-3.5%)	624,388 (-0.7%)	564,863 (-9.5%)	586,523 (+3.8%)	603,200 (+2.8%)	634,526 (+5.2%)
Commercial & Residential Services	244,251	247,415 (+1.3%)	250,318 (+1.2%)	252,803 (+1.0%)	253,682 (+0.3%)	288,542 (+13.7%)	303,650 (+5.2%)	310,026 (+2.1%)
Lodging	606,168	627,354 (3.5%)	740,711 (+18.1%)	758,054 (+2.3%)	510,761 (-32.6%)	664,886 (+30.2%)	711,321 (+7.0%)	716,656 (+0.8%)
Personal Services	460,390	490,915 (6.6%)	519,369 (+5.8%)	547,094 (+5.3%)	475,580 (-13.1%)	527,718 (+11.0%)	551,629 (+4.5%)	577,450 (+4.7%)
Quick Service Restaurants	3,561,108	3,659,560 (2.8%)	3,770,426 (+3.0%)	3,880,612 (+2.9%)	3,544,759 (-8.7%)	3,728,402 (+5.2%)	3,802,722 (+2.0%)	3,937,161 (+3.5%)
Real Estate	242,792	251,046 (3.4%)	256,328 (+2.1%)	262,130 (+2.3%)	245,437 (-6.4%)	265,954 (+8.4%)	274,769 (+3.3%)	273,396 (-0.5%)
Retail Food, Products & Services	953,009	977,712 (2.6%)	1,020,002 (+4.3%)	1,061,686 (+4.1%)	1,014,127 (-4.5%)	1,069,837 (+5.5%)	1,093,196 (+2.2%)	1,133,065 (+3.6%)
Table/Full Service Restaurants	1,043,772	1,069,518 (2.5%)	1,088,352 (+1.8%)	1,116,894 (+2.6%)	923,097 (-17.4%)	1,060,736 (+14.9%)	1,098,153 (+3.5%)	1,110,233 (+1.1%)
Total	7,756,202	7,915,179 (+2.8%)	8,274,532 (+4.5%)	8,503,661 (+2.8%)	7,532,305 (-11.4%)	8,192,600 (+8.8%)	8,438,641 (+3.0%)	8,692,513 (+3.0%)

Chart Data Source: IFA

In terms of growth, an Entrepreneur's Source blog appearing on the IFA site noted that "travel is expected to be one of the largest categories in franchising in 2023. Travel-related franchises are projected to grow between 214 and 318 percent."9 Travel franchises can be defined in various ways, however, most definitions typically include such businesses as travel agencies. Broader definitions may include RV and campsite franchises, for example. Other "hot" franchise categories for 2023, according to Dan Rowe, CEO of Fransmart, are self-care, electronics/gaming, pets, senior care, and home improvement.[10]

When purchasing a franchise there are a number of considerations from costs to the advantages and disadvantages of the partnership.

Costs

Franchising entry costs can vary widely depending, for example, on the industry sector and brand. Franchising.com states on its website that while "costs range from less than $10,000 to upwards of $5 million, the majority of franchises run from about $50,000 or $75,000 to about $200,000 to get started."[11]

According to the Federal Trade Commission, there are a few common costs associated with the purchase of a franchise: [12]

1. **Initial Franchise Fee and Other Expenses:** These typically range from tens of thousands of dollars to several hundred thousand dollars and may be non-refundable. These costs may be associated with renting, building, and equipping an outlet and buying initial inventory. The franchisee may have to pay for operating licenses and insurance and a "grand opening" fee to the franchisor to promote your new outlet.

2. **Continuing Royalty Payments:** The franchisee may have to pay the franchisor royalties based on a percentage of weekly or monthly gross income.

3. **Advertising Fees:** Franchisees may have to contribute to an advertising fund. Some portion of the advertising fees may be allocated to national advertising or to attract new franchise owners, rather than to promote an individual outlet.

As an example, 7-Eleven provides some details regarding financial responsibilities on its website as well as some basic upfront investment information[13]:

Financial Responsibilities for Traditional Franchises

Average costs vary depending on stores and locations, but generally look like this:

WE PAY FOR:

- Real property & building rent or acquisition cost
- Certain equipment purchase or rent
- Real property taxes
- Select utilities (electric/gas/water/sewer)
- Certain building maintenance
- Certain equipment replacement costs
- 7-Eleven advertising
- Initial training material on store operations
- Bookkeeping and back-office support
- Certain inventory audits
- Product development and merchandising assistance
- Ongoing business advisory assistance

YOU PAY FOR:

- Payroll, payroll processing expenses, and payroll taxes for your employees
- Workers' compensation and any employee benefits you choose to offer for your employees
- Business taxes and licenses
- Indemnification and insurance
- Cash and inventory shortage
- Store supplies and miscellaneous store expenses
- Equipment maintenance and overall general repairs
- Outside property maintenance and landscaping
- Telephone (store line only)
- Janitorial and laundry services
- Security expenses
- Grand Opening
- National advertising fee and local store advertising expenses
- Interest expenses
- Other operating expenses
- All taxes other than real property taxes

Your Up-Front Investment

Average costs vary depending on stores and locations, but generally look like this:

- Initial franchise fee (varies by store)
- Training expenses (varies)
- Down payment on the store's opening inventory (approx. $20,000)
- Supplies (approx. $1,000)
- Business licenses (varies by state)
- Permits (varies by state)
- Bonds (varies by state)
- Cash register fund (approx. $2,500)
- Grand Opening fee
- Insurance costs

Chart Source: franchise.7-eleven.com

An alternative way to gauge this market is to look at print page volume. According to IDC, about 450 billion fewer pages were printed from home and office devices worldwide in 2020; this is attributed to COVID-19 disruption. IDC explained that the print volume had been dropping before the pandemic but COVID steepened the decline. 2.8 trillion pages were printed globally in 2020, which is a drop of 14%.

Labor/EmploymentAdvantages and Disadvantages

The advantages and disadvantages of franchising are widely discussed. For franchisees, the primary benefit is being able to go into business on your own but with some variation of support from the franchisor.[14]

The IFA elaborates on these benefits in terms of both pre-opening and ongoing support. When opening a franchise, support from the franchisor may include site selection, design, construction, financing, training, and a grand-opening program.[15] Ongoing support may include training, national and regional advertising, operating procedures, operational assistance, ongoing supervision and management support, increased spending power, and access to bulk purchasing.[16]

According to FranchiseWire, there are strong benefits for franchisees because, in most cases, the franchisor has done a lot of the work to get the business up and running. More specifically, franchisees experience benefits with the start-up stage, training, marketing/advertising, access to purchasing power, and financing:[17]

- Start-up stage: Franchisees don't have to write the business plan, conduct market research, test the product, etc. Essentially, they can reap the benefits of the franchisor's hard work.
- Training: Most franchise companies provide initial training for new franchisees and often their staff. They may visit locations as a follow-up to guide the grand opening phase. Additionally, a lot of brands provide educational videos and webinars to keep franchisees aware of the latest technology and methods.
- Marketing/advertising: The franchisor will help execute marketing campaigns and develop a plan based on market and budget.
- Access to purchasing power: Some franchises may buy large amounts of inventory or equipment, providing the franchisee with reduced costs that are far less expensive than if they were buying these items independently.
- Financing: Some franchise companies provide in-house financing options or guide the franchisee to resources that provide access to funding their new business.

The disadvantages of the franchise relationship focus on the franchisees' lack of independence since ultimately the way the business is run is dictated by the franchisor. For example, franchisors can place restrictions on the products and services offered, pricing, and geographic territory.[18] Costs and fees can also be considered a disadvantage for franchisees. On top of whatever the initial franchise fee is, franchisees also pay ongoing royalties and advertising fees.[19]

The IFA adds, "Franchisees must be careful to balance restrictions and support provided by the franchisor with their own ability to manage their business. A damaged, system-wide image can result if other franchisees are performing poorly, or the franchisor runs into an unforeseen problem. The term (duration) of a franchise agreement is usually limited and the franchisee may have little or no say about the terms of a termination."[20]

Certain industry segments may be more impacted by challenges and disruptions. For example, staffing issues such as recruiting/retaining shift workers can be problematic for restaurants, retail, and hospitality. Car dealerships are going through a period of disruption with the entry of electric vehicles as well as new web-based models for car buying cropping up. In fact, in October 2022 the National Automobile Dealers Association (NADA) issued a set of "guiding principles on its relationship with automakers going forward."[21] According to Automotive News, the framework relates to "evolving business models and the dealer franchise system to provide a more defined path forward for dealers and automakers as they navigate a fast-changing auto retail landscape. The principles, in part, are intended to jump-start deeper, more meaningful discussions between franchised dealers and their automakers. They highlight five broad areas — covering topics from subscription services and over-the-air updates to vehicle reservations and data-sharing — that have become more prevalent, demanding greater clarification of the dealer's role."[22]

Market Size and Growth

Data shows that key market metrics (establishments, employment, and output) had a dip in 2020 but then returned to growth and will continue to grow through 2023 (projected).[23] From the IFA's 2023 Franchise Outlook (published March 2023):

Franchise Business Economic Outlook: 2019-2023

	2019	2020	2021	2022 (Est.)	2023 (Proj.)
Establishments	773,603	753,770	774,965	790,492	805,436
Percentage Change		-2.6%	2.8%	2.0%	1.9%
Employment	8,503,661	7,532,305	8,192,599	8,438,640	8,692,513
Percentage Change		-11.4%	8.8%	3.0%	3.0%
Output ($ Million)	$794,184	$677,236	$787,746	$825,367	$860,144
Percentage Change		-14.7%	16.3%	4.8%	4.2%
GDP ($ Billions)	$473.41	$446.32	$474.16	$500.22	$521.30

Chart Data Source: IFA

According to the American Action Forum:

> Franchising has proved to be a successful business model that supports workers, large businesses, and entrepreneurs. Individuals wanting to start a business have a greater chance of success by opening a franchise, as 92 percent of franchisees remain strong after two years of operation, compared to 20 percent of independent businesses.[24]

The possibility of a recession in 2023 is leading to some "uncertainty" in the franchise market according to Keith Gerson, the president of Franchise operations at FranConnect. He wrote in an October 2022 blog that their sales index data shows a decrease in both total leads and sales in Q3 2022 as compared to Q1 2021. However, in 2023 over 80% of franchisors appear to be expecting an increase in sales/revenues:

- 33% of franchisors anticipate a sales increase of 1-5%
- 30% of franchisors anticipate sales being up 6-10%
- 20% anticipate their franchisees' revenues will increase by 11%
- Only 6% in total believe that they will be negative between 1-5%
- And 6% believe that they will be negative between 6-10%[25]

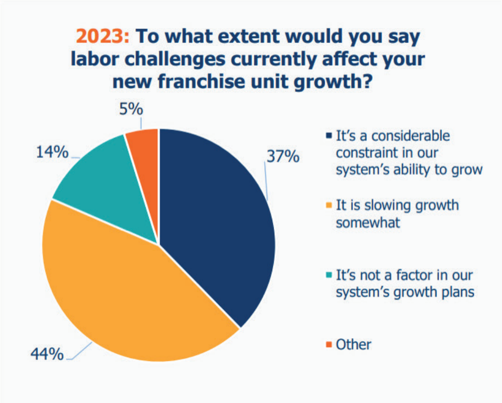
Macroeconomic Environment

There are a number of factors that have recently impacted the space, including those related to labor, shifting demographics, supply chain issues, and economic factors such as inflation.

Labor

It would be hard to find an industry that has not been impacted by the great resignation or labor shortages in the past couple of years. The industries that franchises are most commonly in are no exception. In fact, according to 2023 survey data from the IFA and FRANdata of 169 senior executives representing franchisors and franchise portfolio companies, quality of labor is the most important problem facing franchise businesses today.[26]

Additionally, 87% of franchisors said that their franchisees want to hire but have had difficulty filling open positions, according to the report.[27] Similar to 2022, in 2023 81% of brand executives indicated labor challenges have slowed new franchise unit growth.[28]



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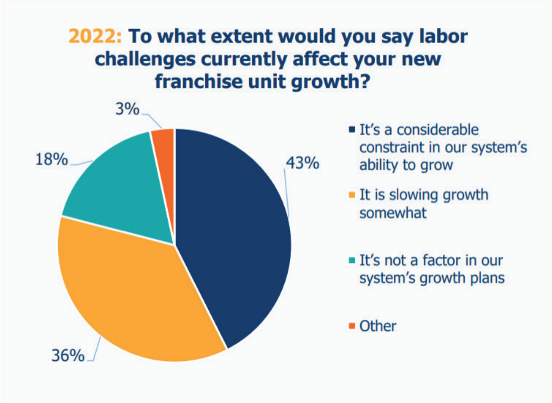


A 2022 labor report from the IFA mentions the ways franchisors worked to fight labor issues

> *"Franchisors have sought to solve the post-pandemic labor crunch in real time, exemplifying the power of the business model and the benefits of a national brand. Franchisors have increased leadership training and goal-setting skills and created unique funds dedicated to recruitment, and some have shifted a portion of expenses from marketing to store-level recruiting for their franchisees. They have also sought to establish a robust online presence, boost online access to management tools, and use technology to their advantage to ease the need for greater labor."* [29]

Various franchise segments require the recruiting and retaining of shift/deskless workers which can create some challenges. Connecteam noted that "studies have shown that some shift workers, especially those who work non-traditional hours, have a higher turnover rate, lower commitment to their organization, and lower job satisfaction when compared with workers who have traditional hours."[30] Ways to combat this, in addition to offering competitive wages and bonuses, can include keeping shifts consistent, soliciting employee input into shift preferences, and having the company culture support work-life balance.[31]

In 2023, franchisors are expecting their franchisees to change wages and increase efficiencies to fight labor challenges.[32]

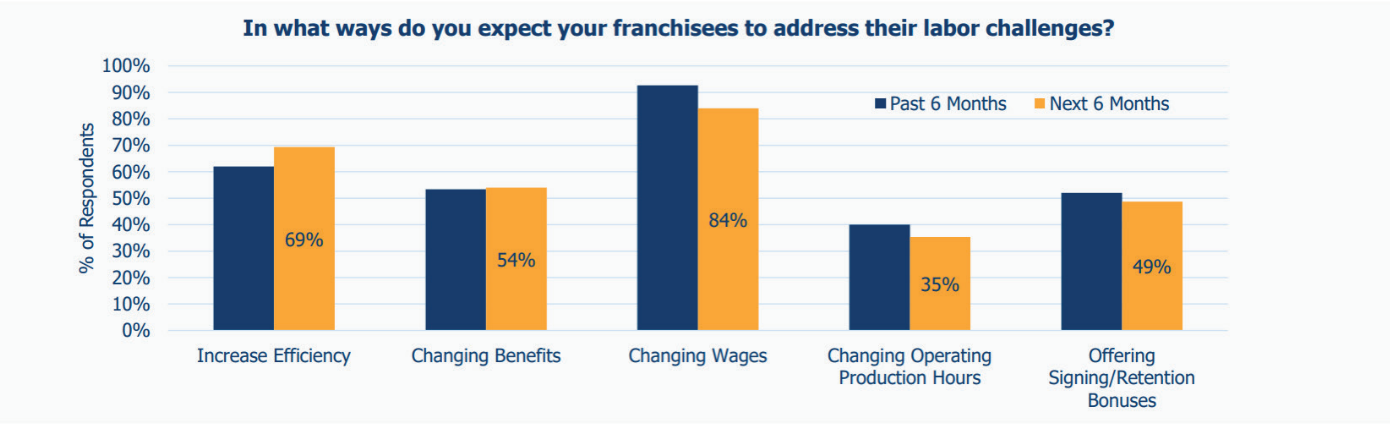


Chart Data Source: IFA

Hotels are one franchise industry that has been impacted by labor shortages. While labor shortages are not new in the hotel industry, the increase in demand for leisure and travel while hotels struggle to bring back employees created an imbalance.[33]

Staffing shortages in the industry are due to a few different factors, including former employees' unwillingness to come back to their old jobs with an increased workload because of a lack of staff. There is also a reputation that the industry has low pay, long hours, bad benefits, and a poor work-life balance.[34]

91% of franchisees said increasing labor cost had some to large impact on their business.

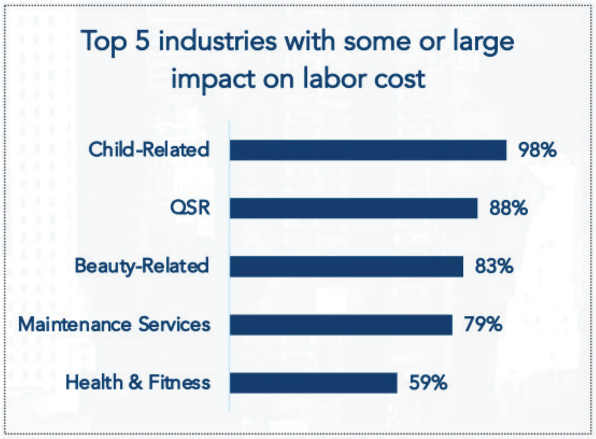


Chart Data Source: IFA

Beyond shortages, the cost of labor has also been an issue for franchises. Labor costs have impacted a range of industries, however, some franchise categories have felt the impacts more than others. According to the 2022 Study on Impact of Labor Shortages, 91% of franchisees said increasing labor costs had some to large impact on their business.[35] Child-related franchises and QSR were most likely to report an impact.[36]

The report found that “more than 64% of survey respondents saw an increase in store-level wages over the past six months, with an additional 18% experiencing significant increases.” Additionally, “franchisors are also expecting wage increases going forward, with 66.4% anticipating additional increases in average employee wages in the next six months and an additional 9.8% anticipating average wages increasing significantly.”

The impact that minimum wage increases can have on businesses was discussed in a study conducted at Penn State.[37]

According to Matt Gustafson, Penn State Smeal associate professor of finance “…when the minimum wage is raised and therefore labor costs go up, these companies are going to take on fewer capital expenditures as investment projects. One of the main ways in which restaurants, stores, and entertainment venues invest is in new establishments. Our research showed that as a state’s minimum wage goes up 10% to 20%, these businesses will invest in fewer establishments in that state in the subsequent year or two. So, let’s say 10 people are thinking about opening up a second store. One or two of them will decide not to — they’ll cancel or delay that new establishment — because of that minimum wage hike.”[38]

The findings above could impact franchises; as the minimum wage rises, fewer franchises may be opened.

Federal Government Regulation Impacting Franchises

According to All Business, the federal government does not regulate franchises however “it does require franchisors to disclose information to franchise buyers with the information they need to know before buying a franchise.”

- FTC requirements – “The Federal Trade Commission (FTC) requires all franchisors operating in the United States to abide by the FTC’s Franchise Rule. This is a federal regulation that requires franchisors to prepare an extensive disclosure document called the Franchise Disclosure Document (FDD) and to give a copy to any prospective franchise purchaser before he or she buys a franchise. The FDD consists of many different categories about the franchise such as required fees, basic investment, bankruptcy, and litigation history (including any felony convictions and civil judgments), a list of current and former franchisees, a financial statement of the franchisor, and earnings claims (if the company makes them) and the franchisor’s executives, as well as their past experience.”
- State requirements – “In addition to FTC requirements, 14 states require franchise companies to file or register their franchise offerings with a state agency. These include California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. Other states regulate the offering and sale of “business opportunities,” which may include the offering of a franchise under the state’s definition of a “business opportunity” through so-called “business opportunity laws.” These include Alaska, California, Connecticut, Florida, Georgia, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, New Hampshire, North Carolina, Ohio, Oklahoma, South Carolina, South Dakota, Texas, Utah, Virginia, Washington, and Wisconsin.”[39]

There is a Congressional Franchise Caucus, established in 2016, "to promote the franchise business model in the United States." This bipartisan group is co-chaired by U.S. Reps. Kevin Hern (R-OK), Josh Gottheimer (D-NJ), Beth Van Duyne (R-TX), and Tony Cárdenas (D-CA).[40]

In June 2022, the IFA "led 16 business groups in encouraging members of Congress and the FTC to retain the FTC's Franchise Rule, which is reviewed every 10 years."[41]

For 2023, according to the IFA and Paychex, challenges facing franchises "include potential legislation and government regulations that could impact how businesses classify workers, pay workers, and provide paid time off for workers." In March 2023, the IFA and Paychex put together this list of regulatory issues facing franchisors, franchisees, and other businesses in 2023:

- Decennial Review of the FTC Franchise Rule (noted above)
- Joint Employment
- FAST Recovery Act (CA)
- Small Business Funding/SBA lending
- Pay Equity
- Employee Classification
- Encourage Retirement Savings
- Wage and Hour Regulations
- Paid Leave
- Privacy/Cyber Security[42]

Economic Factors

According to the 2022 Franchisee Inflation Survey, 90% of franchisees said they were experiencing a moderate to substantial impact from inflation.[43] One franchise owner was quoted as:

> *"We have experienced a 25% increase in cost of goods from inflation that has reduced net bottom line by almost 50%. Inflation has added significantly to the investment to open new stores. That means the ROI for new stores is way down."*

Additionally, rising costs of fuel and labor are areas creating the biggest impact for franchises. [44]

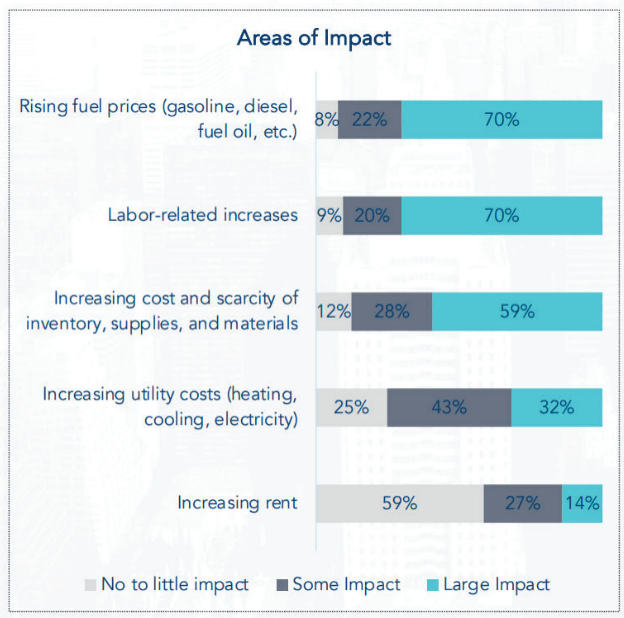


Chart Data Source: IFA

Being a part of a franchise during a period of inflation can be beneficial. Franchisees say that the best franchise tools to help them deal with inflation are sharing best practices, customer marketing, and buying supplies.[45]

Chart Data Source: IFA

Another economic factor impacting franchises and businesses, in general, is rising interest rates. According to Forbes, rising interest rates can reduce a business's ability to service debt and lead to slower growth.[46]

Supply Chain

Supply chain issues have impacted businesses across industries. In fact, according to the IFA's 2022 Franchisee Inflation Survey, 87% indicated that the increasing cost and scarcity of inventory, supplies, and materials has had at least some impact on their business and 59% say it had a large impact.[47]

QSR and retail are among the top industries experiencing a large impact on their inventory cost.

In 2022, retail was faced with a shortage of truck drivers, a lack of available warehouse space, and rising consumer demand, which all impacted retail operations.[48]

Chart Data Source: IFA

Having a shortage of truck drivers means fewer goods are moving at one time and customers are ultimately having to wait longer for their items to arrive.[49]

A lack of warehouse led to four in five retailers at one point repurposing their store space into additional fulfillment space, according to research from Linnworks.[50]

Faced with growing consumer demand, it was more critical than ever that retailers had the proper tools and platforms in place to keep track of sales, and operations and help forecast demand.[51]

Implementing Price Increases

Between rising labor costs, inflation, and supply chain issues, franchises have grappled with the decision to implement price increases. According to the IFA's 2022 Franchisee Inflation Survey, 80% of respondents representing 89% of units raised their prices of goods and services to absorb cost increases. QSR and retail stores were the top two industries to raise prices.

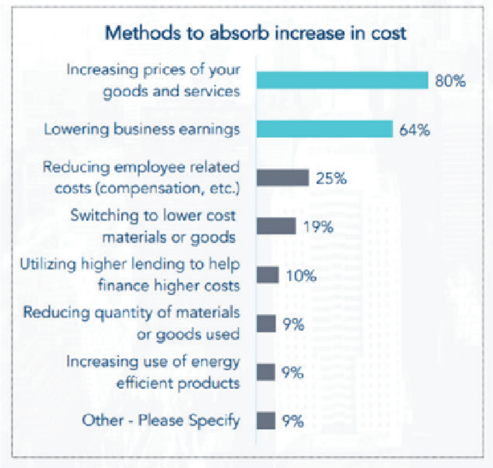


Chart Data Source: IFA

Chart Data Source: IFA

According to Paul Westra, managing director of restaurant investment research at Capital One, "input cost inflation ran well ahead of menu pricing."[52] As of November 2022, average menu price increases were around 6% in the last 18 months, however, according to Westra, restaurants would need to aim for an 11% increase to protect profits.[53]

Shifting Demographics

This generational shift is also being felt by franchises. According to Franchise Insights, in 2021 Millennials were seeking out franchise opportunities more than Baby Boomers.[54] While Millennials are second to Gen X, franchise organizations should still be looking for new ways to attract a younger audience.

> *"Focusing on the flex benefits of franchising combined with cutting-edge technology, the opportunity for entrepreneurship, and a strong income at an early age are all things that can combine to create a desirable opportunity for millennials. Highlight the impact the business has on its community. Use technology and design to make the business what consumers are looking for with apps, two-way communication tools, and more. Meet millennials where they are online in places like Instagram, TikTok, and Snapchat. Help them connect with people who can support their vision. Combine all these elements together, and the franchise model will be more attractive than ever to the newest group of up-and-coming franchisees."*[55]

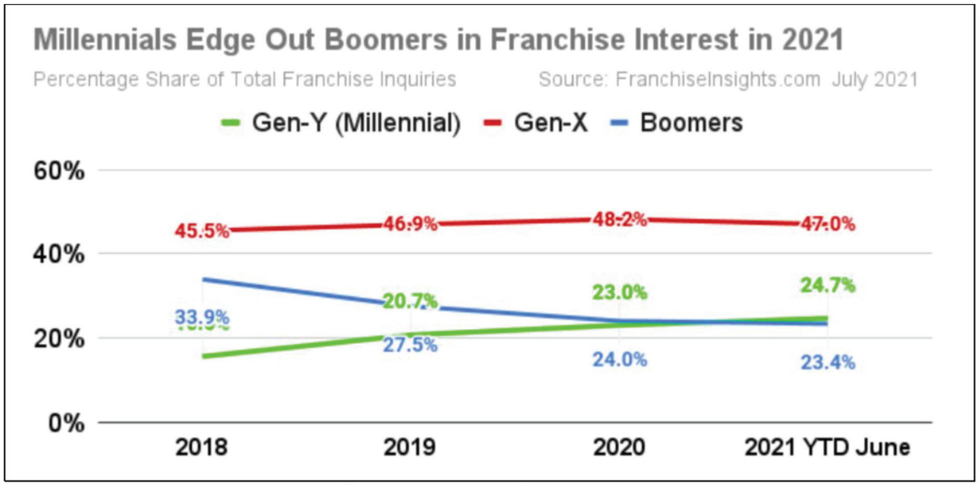


Chart Source: Franchise Insights

Research from Franchise Insights also shows that women's interest in franchises declined during the pandemic but rebounded in 2021.[56]

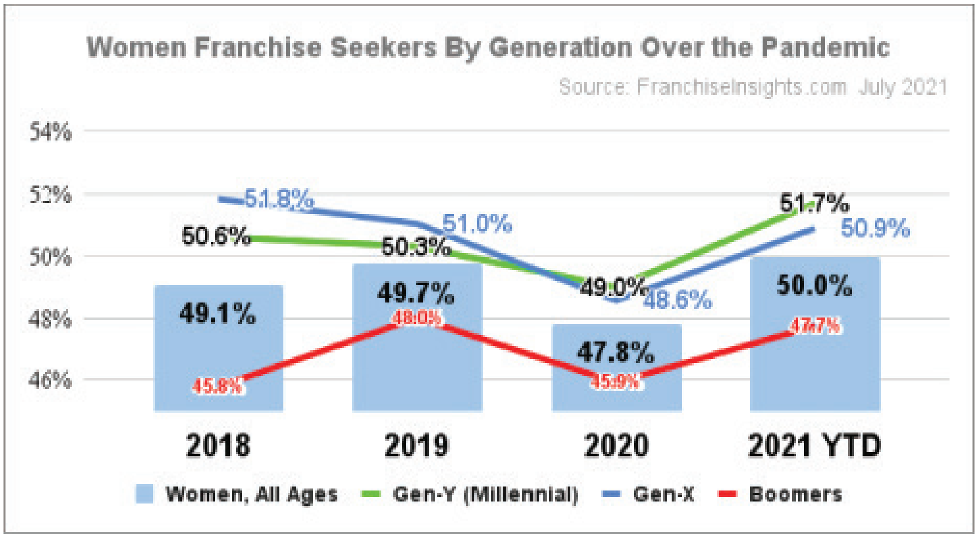


Chart Source: Franchise Insights

Trends, Growth Segments, Opportunities

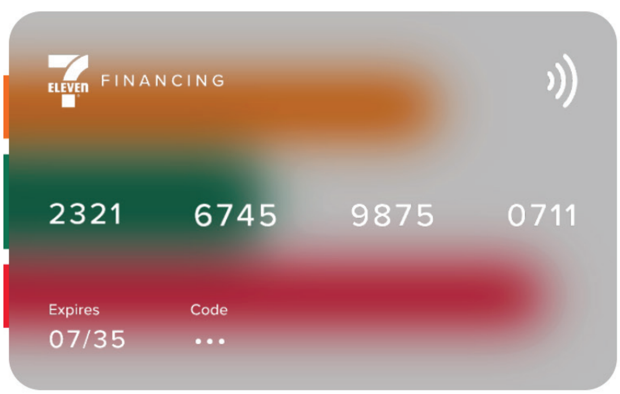
Franchise Financing Options

Franchisees have several options to finance a franchise purchase. ADP mentions the following:[57]

- Franchisor financing: In some cases, franchisors may offer financing directly through the parent company. However, it is more common that they partner with preferred lenders who give loans to their franchisees.
- Commercial bank loans: Another option for franchisees is to apply for a commercial loan. Approval is usually contingent on a good credit rating and having a detailed business plan.

- Small Business Association (SBA) loans: Other franchisees may look into SBA loans because they generally have more favorable interest rates and repayment terms than commercial banks loans. Type 7(a) loans are ideal for new franchises, while 504 loans have more limitations.
- Alternative lenders: If unable to secure a commercial bank loan or an SBA loan, alternative lenders may be an option. Their approval process is faster and less rigorous than traditional lenders, however, the interest rates can be higher and the repayment periods are shorter.
- Personal assets: Savings accounts, severance packages from previous employers, and home equity and retirement savings plans are sometimes used to help finance a franchise.
- Rollovers as business startup (ROBS): A method of withdrawing money from a 401(k) or other retirement savings accounts to fund a new business without penalties.
- Crowdfunding: If other options have not worked, franchisees may attempt to raise money via online forums.
- Friends and family: Borrowing from friends and family can be a good choice for those who have poor credit ratings or can't afford to pay interest.

7-Eleven is an example of a franchise that offers financing support[58]:



Financing

If you're serious about franchising, and if you qualify, you can take advantage of 7-Eleven programs created to help qualified Franchisees succeed.

If you qualify, 7-Eleven has an internal program that provides up to 65% financing on your initial franchise fee. This program, which is uncommon to most franchisors, also provides an open account (or financing) for the inventory purchases and operating expenses of your store. The amount financed generally fluctuates from month to month based on your sales, inventory, purchases, operating expenses, and withdrawals from your store's open account. Your Franchise Sales Representative can provide you with additional details.

Chart Source: franchise.7-eleven.com

Equipment/Supply for Franchises

There are different arrangements regarding who is financially responsible for franchise expenses and the role that the franchiser vs. the franchisee will play in both the upfront investments as well as the ongoing costs of doing business.

Once a franchise is purchased, franchisees will have to buy equipment, usually from an approved list of vendors and prices.[59] Wendy's is one example of a company that requires franchisees to "purchase equipment, food products and some supplies and services from Wendy's approved suppliers. They must purchase or lease products or services which conform to Wendy's specifications."[60]

Franchisees are typically responsible for buying the equipment, but franchisors can offer support in areas such as:

- Finding the best deals on your equipment
- Purchasing the right inventory and products
- Installation and training on using the equipment [61]

As an example, here are some details regarding equipment-related costs for a full shop Auntie Anne's that were reported by franchisechatter.com in August 2022[62]:

- Equipment Package: $21,000 to $60,000; You must purchase or lease from an Approved Supplier certain equipment (like kitchen equipment) and machinery that comply with the franchisor's Standards.
- Furniture: $0 to $2,500; You must purchase from an Approved Supplier furniture, such as tables, chairs, and office furniture, that meets the franchisor's Standards.
- Menu Board, Graphics, and Interior Signage: $250 to $12,000, This estimate includes the cost of a digital menu board and interior signage. A digital menu board is required for a Full Shop.
- Exterior Signage: $1,500 to $7,000; The cost of your exterior sign will vary depending on the size, color, quantity, and backlit channel letters of the sign and other specifications as the franchisor requires. The cost of the signage for a kiosk could be as high as $18,000 because of the need for signs on multiple sides of the kiosk.
- Computer System: $6,000 to $24,000; You must purchase, lease, and/or license and install at the Shop the POS System, computer systems, mobile hardware, software, online ordering platform, associated computer hardware, telephone lines, network connections, communications equipment, high-speed internet access (e.g. DSL or cable), credit card, gift card and loyalty card processing equipment, and other equipment that the franchisor requires from time to time (collectively, the "Computer System"). The Computer System currently includes a back-office PC, one monitor, one back-office multi-function printer, between one and four POS System terminals for a Full Shop, one firewall device, a dedicated iPad or Windows tablet/computer, and one POS System server in addition to other related software, phone and network connections, and equipment. You may also be required to purchase training software from a vendor that the franchisor designates.
- Smallwares: $1,000 to $4,500; This estimate includes the cost of purchasing cooking utensils, supplies, other small wares, and other tools necessary to operate the Shop.

McDonald's mentions that the upfront cost for a franchisee may vary depending on the equipment needed:

> **Equipment and Pre-Opening Costs**
> Typically, these costs range from $1,269,500 to $2,268,295. The size of the restaurant facility, area of the country, pre-opening expenses, inventory, selection of kitchen equipment, signage, and style of décor and landscaping will affect new restaurant costs. These costs are paid to suppliers.[63]

Franchisees starting a franchise that already has many locations may be able to get a better deal on equipment if the franchising company is already buying equipment in bulk.[64]

A franchise concept that could have an impact on the purchasing of supplies and equipment is the umbrella brand. Simply put an umbrella brand “maintains ownership of an entire family of brands under one name.” Here are some examples provided by Entrepreneur[65]:

> **Inspire Brands** – “Under the Inspire Brands umbrella, you'll find well-known franchises such as Dunkin', Baskin-Robbins, Sonic, Arby's, and Jimmy John's...that amounts to more than 32,000 restaurants in 60 different countries.” (as of March 2022)
>
> **Neighborly Brands** – “What began as a single-brand shop in 1981 has since grown to become a home services franchise conglomerate. Neighborly Brands includes 29 different brands, including the well-known concepts of Mr. Handyman and Molly Maid. To date, they've established 4,800 franchise operations in nine different countries.” (as of March 2022)

Red Boswell (President of the International Franchise Professionals Group) commented in a January 2023 *Franchise Industry News* piece that “in 2022, many brands joined forces and created new umbrella groups. The result? More professional franchise brands with stronger systems and support for franchisees” and he is predicting more of the same going forward. [66]

The umbrella model may provide benefits in purchasing and help to weather economic challenges:

> But the umbrella franchises have their benefits. One overall plus may be that they have the backing of deep-pocket investors who lend stability and staying power when times are tough because of a sluggish economy, weather disasters, and the current grind of the pandemic.
>
> Economy of scale helps umbrella franchisors secure advantageous contracts with vendors for everything from restroom paper towels to cleaning supplies, foods, and other types of operational supplies, and machines to software. They often have seasoned executives – some with enticingly diverse expertise – at the helm; these leaders can put their experience and contacts to work in negotiations to help franchisees. The umbrella franchise companies may be able to be more cost-effective because of cost-sharing for services such as accounting, legal, and human resources.[67]

Technology in the Franchise Industry

Many franchise industry categories can benefit immensely from advancements in technology. According to FranConnect data, 50% of franchisees felt that “technology tools were among the top values a franchisor provides.” And on the franchisor side, the study reported, “Franchises are recognizing there may be limits to their expansion unless they keep pace with technology needs.”[68] Technology can also help ease some of the issues franchises are facing with labor and supply chain issues.

For example, contactless payments is predicted to be a top trend in franchising as more consumers expect smooth transactions.[69] Having innovations such as automated and digital payment methods in place can be a way to reduce labor costs. Similarly, restaurants can create efficiencies through self-ordering kiosks, digital menu boards, and offering online ordering.[70]

Providing franchisees with the right technology tools can also help with franchise growth. According to Adam Zeitsiff, Chief Information Officer at Smoothie King:Keypoint Intelligence offers its opinion on the topic:

> *"It's important that we give [franchisees] the right tools to help them run their business efficiently and maintain a competitive edge, so they can spend more time working to grow their business."* [71]

Retail is one category utilizing various technologies to improve customer experience, allow for more efficient analysis of data, and improved use of employees. Innovations ranging from the use of virtual reality to "try on" products, indoor positioning/AR navigation, contactless payments, and the use of robots are being deployed.

Another way technology is being utilized is in the buying and selling of franchises. A Fast Company article reports that digital platforms are beginning to disrupt the purchase process:

> By creating an open marketplace in which competition can thrive, interests between franchisor and franchisee will be better able to align.
>
> Digital platforms are delivering this transparency by providing more than 4,000 franchise disclosure documents, upwards of 5,000 company profiles, and a whopping 50,000+ company key performance indicators (KPIs) from franchises around the globe.
>
> By creating an account with one of these platforms, prospective franchisees can shop all the data in one location. Everyone gains unlimited access in the digital platform's open marketplace, so franchisors and franchisees can be compared side-by-side to find the best fit.[72]

Examples of these platforms include Franchise123 and BizBuySell.[73]

Case Studies

Technology in Hospitality

In hospitality, implementing technology with new tools and platforms can benefit both the businesses and guests. Benefits of hotel automation include reduced labor costs, more support for short-staffed teams, streamlined operational services, and an improved guest experience.[74] In fact, 65% of hoteliers said incorporating new technologies is a major piece of their strategy to fight labor shortages and attract new talent. [75]

Beyond creating efficiencies for staff, guests are also seeking out hotels with smart technology to minimize contact with staff and other guests. A study done by Skift showed that 73% of consumers were more likely to stay at a hotel that offers self-service technology. [76]

Hotels are implementing smart technology such as smart door locks to increase smooth check-in. This may look like guests getting a key on their phone instead of having to visit the front desk. Other technology opportunities for hotels include:

- Using check-in kiosks also has the potential to speed up the check-in process for hotel guests.
- Having informational and interactive kiosks to replace visiting the concierge for information such as weather updates, traffic reports, nearby events, and more.
- In-room digital technology for guests to request services.[77]

Hilton is one hospitality franchise that has embraced the use of technology. More than 80% of Hilton's properties support its Hilton Honors smartphone apps and by October 2021 digital keys had been used to open more than 135 million guest rooms according to the brand.[78]

> *"Hilton's smart hotel solutions are another sign of the progress that smart home technology has made in the past years."*
>
> • Jonathan Collins, Smart Home Research Director at global technology intelligence firm ABI Research.
>
> Marriot has also rolled out smart locks and mobile app access to its hotel rooms.[79]

Automation in QSR

Automation is continuing to evolve in the QSR space as brands look to implement efficiencies in the face of labor shortages. According to QSR Magazine, "automation can help get orders to people faster, improve the conditions for staff, increase profit, and place the business at the forefront of its competitors."[80]

There are a number of ways automation is being implemented in the QSR Space:

6. Drive-Thru Ordering: Automated order-taking (AOT) technology allows customers to place orders through artificial intelligence. AOT has natural language processing and can understand orders in multiple languages and dialects. Customers can also add modifications or request various menu items.
7. Kiosks and Mobile Apps: Many restaurants use apps or delivery services like DoorDash or Grubhub to prepare orders ahead of time, allowing customers to easily come in and pick up their orders. To improve efficiency, some restaurants are considering specific lanes for mobile orders only. Inside the store, kiosks allow customers to place their orders efficiently.
8. Robo-cooks: Restaurants are starting to introduce robots for cooking. This technology uses AI to recognize the differences in items to detect when they are ready.
9. Fresh Food Storage: AI and sensors can recognize imperfections or mold and remove items from the supply chain early on. The tech could also sort food by size, weight, and ripeness.
10. Monitored Safety and Hygiene: There is potential for store owners and managers to use facial recognition software to monitor proper safety and hygiene standards, such as checking for face mask usage to cleaning tasks, and machine maintenance.
11. Delivery Robots: Robots are being used for delivery across college campuses and there is an opportunity for brands to adopt this technology as well. [81]

Some brands have already started using the technology mentioned, such as McDonalds partnering with IBM to implement AOT technology into its drive-thrus. This has helped improve customer and staff experience:

Another pricing option is building the entire print program cost into a per-page charge:

> "Fully automated driving lanes let customers fly through complicated orders without the worry of being drowned out by roaring engines or having multitasking employees miss an item. Staff members can now focus on cleaning or helping customers without turning away to take an order over the headset."[82]

White Castle tested out “Flippy,” a robot used for burger grilling. The feedback from this pilot program was used to improve the machine, showing continued growth in robotics use for QSR.[83]

Other tech advancements in QSR include Domino’s partnering with Robotics company Nuro to test autonomous pizza delivery.[84]

In Conclusion

As with other businesses, franchise owners are being challenged on several fronts. The uncertainty about a possible recession, staffing difficulties, and costs associated with implementing new technologies all may impact a franchise owner's decision to invest in their current franchises or to increase their holdings. These factors could also complicate a potential franchise owner’s decision to enter the sector.

However, on the bright side, the franchise market has shown growth across key metrics. Matt Haller, CEO and President, IFA, stated in a November 2022 Franchising World article, “Despite economic headwinds, franchising has continued to grow and prosper, creating opportunities in every community around the nation. That doesn't mean there haven't been challenges—from the labor shortage, record inflation, rising interest rates, and supply chain bottlenecks. However, franchising has continued to show its strength and resiliency, particularly when compared with other business models.”[85]

Additional Information:

The U.S. Small Business Administration (www.sba.gov) is a good resource for additional information regarding the franchise sector.

Defaults could be a consideration for some franchise lenders. William Bruce President of American Business Brokers Association and Business Broker and Accredited Business Intermediary published an analysis of the best and worst franchises ranked by SBA loan default rates in June 2020. This can be viewed at William Bruce Best and Worst Franchises.

About the Researcher

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