Key franchising terms defined

Discover the key phrases and understand the terms and definitions relevant to franchising.

Advertising fee

An annual fee paid by the franchisee to the franchisor for advertising expenditures, it’s either a fixed amount or a percentage of the franchisee's annual sales and usually paid in addition to the royalty fee. Not all franchisors charge advertising fees.

Business format franchising

The franchisor licenses a complete plan (i.e., a business format, operating system and trademark) to the franchisee. The plan provides step-by-step procedures for major aspects of the business and, anticipating most management problems, provides a complete matrix for management decisions confronted by the franchisees.

The franchisor also teaches the franchisee the entire business format and provides support via training and communications to the franchisee for the duration of their business relationship.

Business plan

A document that summarises the operational and financial objectives of a business, it contains detailed plans and budgets showing how the objectives will be realised. It's vital for business planning as it shows detailed financial projections, forecasts about your business' performance and its marketing.

Capital required

The amount of cash you are required to have available.

Company-owned units

These are locations that are owned and run by the parent company (the franchisor) rather than by franchisees.

Copyright

The exclusive right of a person to use, and to license others to use, an intellectual property such as a book, pamphlet or other published material.

Demographics

A range of factors that may influence consumer behaviour in a specific trade territory, e.g. age, income, house prices, industry and socio-economic conditions.

Designated supplier

Approved, chosen suppliers of products and services, all of whom meet the requirements of the franchise company.

Disclosure document

All members of the Franchise Association of South Africa (FASA) are required to provide this legal document to prospective franchisees. The document aids the prospective franchisee's evaluation of the franchisor company.

The minimum amount of information a disclosure document must provide is as follows:

1. Full and traceable information about the franchisor company, including contact details and details of professional affiliations
2. Details of qualifications and business experience of the franchisor and his/her officers in the type of business being offered as a franchise, and the operation of a franchise
3. Details of criminal or civil action against the franchisor or his/her officers, either taken during the past three years or pending
4. Full details of the franchise offer and the underlying business
5. Full details of the obligations of the franchisor vis-à-vis the franchisee
6. Full details of the obligations of the franchisee vis-à-vis the franchisor
7. An explanation of the most important clauses of the franchise agreement, including restrictions placed on the franchisee
8. Financial projections for at least two years and an explanation of the basis on which these projections were calculated
9. Full details of all payments, initial and ongoing, the franchisee will be expected to make and what he/she can expect to receive in return for these payments
10. A list of existing franchisees and their contact details

11. An auditor’s certificate certifying that the franchisor’s business is a going concern and can meet its obligations as they fall due
12. A statement by the franchisor to the effect that to his/her best knowledge and belief, the financial situation of the franchise company has not deteriorated since the day the auditor’s certificate was issued

FASA prescribes that the disclosure document must be updated at least annually or more frequently should material changes within the franchisor’s business take place.

Estimated initial investment

A detailed listing of all fees and expenses you can expect to incur in starting your franchised business. This listing represents the total amount that you would need to pay or get financing for, including fees paid to the franchisor, estimates for furniture, fixtures and equipment, opening inventory, real-estate costs and insurance inventory. This estimate should include a provision for working capital through the start-up phase.

Exclusive territory

Where the franchised business is to be operated from a single location, the franchisee may receive exclusivity solely to that site or a market area usually a set distance surrounding the location. In a mobile service business, the franchisee may be awarded a geographical territory large enough to ensure growth potential.

A franchise system can be impaired by having too many franchisees in one market where there may not be enough business to support them, but on the other hand, a cluster of units where they are not directly competing can take advantage of the synergy that is created by dominating the market, keeping out the competition and benefiting from joint marketing promotions.

Expansion plan

A technique by which franchises are to be sold, including the number of sales anticipated within a series of time periods (first year, second year etc.), to whom those sales are to be made (profile of the individual, area franchising and sub-franchising) and the anticipated geographical expansion of the franchise system.

Franchise

Franchising is the practice of selling the right to use a firm's successful business model. A franchise is a grant by the franchisor to the franchisee, entitling the latter to the use of a complete business package containing all the elements necessary to establish a previously untrained person in the franchised business to enable him/her to run it on an ongoing basis, according to guidelines supplied, efficiently and profitably.

For the franchisor, the franchise is an alternative to building ‘chain stores’ to distribute goods that avoids the investments and liability of a chain. The franchisor's success depends on the success of the franchisees. The franchisee is said to have a greater incentive than an employee because he or she has a direct stake in the business.

Franchise agreement

The written contract, included in the franchise disclosure document, which outlines the responsibilities of both the franchisor and the franchisee, it is usually for a several-year term, and when the term is up, the contract expires or must be renewed.

Usually, a franchise agreement may not be sold, transferred or otherwise assigned without the franchisor's permission. It describes the franchisor's commitment to the franchisee and includes information about territorial rights of the franchisee, location requirements, training schedules, fees, as well as the general obligations of both the franchisee and the franchisor.

Franchisee

The franchisee buys the right to run a business using the trademark and trading system of the franchisor. The business is run according to the procedures set out in the franchise operating manual and under the terms of the franchise agreement.

Franchise contract

The legal agreement between the parties which sets out the terms under which the franchisee will operate the business. The terms usually include the following:

- The right to use the trade name
- The franchisee's obligations
- The franchisor's obligations
- The premises and the territory
- Length of franchise contract

- Financial aspects, such as initial franchisee fee and ongoing royalties
- Renewal terms
- Control of standards
- Rights of sale
- Performance targets
- Termination
- Effects of termination

Franchise feasibility studies

Franchising can be a highly effective method of financing expansion through the acquisition of outside capital. The objective of a franchise feasibility study is to determine the degree to which a company, whether a well-established concern, a small operation of one or two units or simply a concept that bears the characteristics of a successful franchisor, may be successful as a franchisor.

Franchise fee

The initial fee paid to a franchisor to become a franchisee, it is paid by the franchisee to the franchisor to ‘buy into’ the franchise. Generally, the fee reimburses the franchisor for the costs of initial training and support for new franchisees.

Franchisor

The parent company that allows individuals to start and run a business using its trademarks, products and processes, usually for a fee. The franchisor owns the business system and associated trademarks or trade names. Franchisors allow franchisees to use these under licence in a designated area and for a fee. They then support their franchisees both in starting their business and in continuing to make it work.

Master franchise

A master franchisee serves as a sub-franchisor for a certain territory. Master franchisees can issue franchise disclosure documents, sign up new franchisees, provide logistical support and receive a cut of the territory's royalties.

Master franchisee

In master franchising, the franchisor grants the master franchisee the right to act as the franchisor in the target territory. The master franchisee may open his/her own outlets or sub-franchise or open both. The primary advantages to the franchisor of master licensing are that limited capital investment is required, you can tap into the master franchisee's knowledge of the local market and you only have to deal with one party.

Multiple unit franchising

The franchisor awards the right to a franchisee to operate more than one unit within a defined area based on an agreed upon development schedule. If the franchisor decides to expand into a new geographical area which may be a city or province and does have the resources or staff to handle this growth him/herself, a master franchise, sub-franchise or an area development agreement is structured with a party who will use their resources to develop the franchise network by granting unit franchises to others or establish their own outlets and provide the training and local ongoing support.

Non-disclosure agreement (NDA)

A confidentiality agreement that prevents people from disclosing information that is private, valuable or both, it ensures that prospective franchisees can't use information pertaining to the franchisor's brand and business model in competition against them or pass it onto someone else.

Operating or operations manual

Comprehensive guidelines advising a franchisee on how to operate the franchised business, it covers all aspects of the business, including general business procedures not necessarily peculiar to the franchised business. It may be separated into different manuals addressing such subjects as accounting, personnel, advertising, promotion and maintenance.

Protected territory

A designated area or geographic boundary granted to the franchisee by the terms of a franchise agreement. The franchisor agrees not to open another franchised or company-owned business of a like or exact nature within the franchisee's protected (assigned) territory.

Qualification questionnaire

A document prepared by the franchisor to be completed by the prospective franchise which provides initial information to the franchisor to assist him/her in determining whether the prospect is capable and motivated. Often a financial statement is included in the questionnaire format.

Quality control

The method by which the franchisor enforces the rules of operation outlined in the operating manuals, it involves regional coordinators visiting each franchisee.

Royalty fee

Most franchisors require franchisees to pay a fee regularly (weekly, monthly or yearly). Usually, it's a percentage of sales; sometimes it's a flat fee. Some franchisors also require a separate royalty fee to cover advertising costs.

This royalty fee is for the following:

- Compensation for the continuing services given by the franchisor (for training and field services)
- Payback financing of the true market value of the franchise. Royalty payments can be either fixed amounts, based on a percentage of gross sales, or based on a sliding scale, with graduated breakpoints

Start-up cost / initial investment

The total amount required to open the franchise, it includes the franchise fee along with other start-up expenses such as real estate, equipment, supplies, business licences and working capital.

Total investment

The amount of money estimated for complete set-up of a franchisee's business, including the initial investment, the working capital and subsequent additions to inventory and equipment deemed necessary for a fully operational and profitable enterprise.

Trademark

A distinctive name or symbol used to distinguish a product or service from others, it can be used exclusively by the owner, and no one else can use it without the owner's permission. Part of a franchise's value is the right to use a recognised trademark.

Trade secret

This is knowledge in the possession of the franchisor which is revealed to the franchisee by the franchise transaction. Among others, trade secrets may take the form of construction or operating procedures, a formula for the mixing of ingredients to prepare food or the customer list. Appropriate legal provisions written into the franchise agreement, such as a covenant not to compete, are important in protecting these.

Unencumbered funds

A financial institution looks at the expected cash flow generated by a franchise and determines the amount of debt that the franchise can sustain. The purchaser must provide the difference between this amount and the cost of the newly acquired franchise; this is known as unencumbered funds. Unencumbered funds are necessary to buy a franchise because if the franchisee borrows 100% of the funds, from a bank or other sources, the business will be over-geared.

The franchisee will have to make huge repayments every month, and it's unlikely that a young business will be able to afford this. Also, banks want to see the intent of the franchisee to take some risk by also investing in the business.

Most franchisors and banks require the franchisee to invest 50% of their own funds in cash into the business. In some instances, such as petrol stations and retailers, this amount can drop to 30%.

Working capital

Initially, funds are needed to pay the first and last months' rent, utility deposits, licences and incidental costs. As it takes time to build up a new business, the first months are usually loss months, which need to be financed.

For a business to succeed, they need enough cash in the bank, trade credit, borrowing capacity or cash flow to meet start-up expenses and see the business through any unusual dips and changes in its daily activity.