Franchise industry guide

Best practices to propel your business forward

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Contents

Make the march.

Franchising has been growing at a steady clip and continues to be an important economic engine in the United States. According to the International Franchise Association's 2018 Franchise Business Outlook, the number of franchise establishments is expected to hit 759,000 locations in 2018, and franchise employment is forecast to grow nearly 4 percent.

With an upward trajectory that shows no sign of slowing down, franchising is an exciting place to be. The economics are strong, and investment interest is high. New brands and concepts are coming onto the scene; older brands are being reinvented; and many franchises are revamping their operations and processes.

Given all the energy, however, competition is on the rise. Franchisors and franchisees that succeed and grow need to be continually on the lookout for new opportunities as well as ways to improve operations — through adopting new technologies, leveraging customer data for important insights, or maximizing their tax position. That's why Plante Moran's team of dedicated franchise professionals is always scanning the business landscape for fresh ideas they can bring to clients to help them achieve their goals and make the mark.

In this guide, we dive into some of the best practices our professionals have identified — from talent management to location selection — during the course of their work with franchises across multiple industries. We hope it'll spark your thoughts about how you can propel your own business forward.

As always, our franchise team is here to help you continue on your journey. **Let us help you make the mark.**

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Let your data do the driving

Data is often a source of overwhelming confusion. But when it's organized, structured, combined, and analyzed in a thoughtful manner, it leads to insights that can not only improve your business, but also help you grow it.

Many franchisors and franchisees have dashboards that provide snapshots of store performance — but snapshots represent a single point in time. Without the ability to drill down into the data and analyze it for trends, it's impossible to get at the why. And without the why, any action plan will be based on guesses and intuition. For an effective approach to data analytics, you'll need to think through the following steps:

STRUCTURE.

Setting up a data structure is critical to derive meaningful insights. For example, if you're a restaurant and want to track the impact of adjustments to store menus, make sure you're pulling in sales data for individual menu items rather than for entrees as a whole. Creating a structure at the outset will save you from having to reorganize your data once it's already housed in your systems — a much more onerous process.

GATHER.

To derive richer insights, use a range of sources. Point-of-sale (POS) data is one robust source that includes information like the number of customers, items purchased, and purchase size. Other sources are valuable as well, including distributor data, loyalty programs, and customer relationship management (CRM) systems, as well as shopper surveys, website feedback, and social media feeds. Don't wait to start gathering information — the bigger you become, the harder it will be to get your arms around all your data!

Get the most out of your data

To truly deliver actionable insights, data needs to be:

- Scrubbed clean.
- In a consistent file format.
- Broken down into meaningful units and subgroupings.
- Gathered and blended across data sources to tell the full story.

AUTOMATE.

Automation is the key to accurate and timely reporting. If you're constantly running manual reports and then loading the information into Excel spreadsheets, you'll always be one step behind.

ANALYZE.

Data analysis is what will uncover the "hidden gems" of your organization — the interrelationships and causality behind the activities that make up your business. By applying different analytic techniques, you can drill down into why things are happening. Why are sales down at a particular store? Why is a particular item suddenly flying off the shelves? But perhaps even more important, you can use statistical modeling to predict what might happen if you make a particular change to your business, whether it's changing a menu item or revamping your floor plan.

STRATEGIZE.

At this stage, you're ready to move from gathering and poring over data to identifying relations and pursuing opportunities. As you begin to understand the levers that can be used to foster growth, you can develop tailored sets of recommendations for everyone in the organization, from the marketing department to operations to the CEO. Now it's official: Data can drive strategy.

Making location work for you

For franchisees and franchisors, business success can be as much about good real estate decisions as about efficient operations. For franchisees starting out, site selection is paramount. For larger operations, efficient management of leases across all stores becomes a competitive advantage.

FINDING THE RIGHT SITE

Choosing a location is one of the biggest decisions any franchisee can make. In fact, the right location and exposure will more than make up for any costs associated with the real estate. Of course, what constitutes the "right" location will depend on the nature of your business. If you're selling donuts, you want your store where it's easily accessible to commuters on their way to work. Selling pizza? You need to be conveniently located for their ride home. If your core product is more of an impulse purchase, then other nearby tenants might be the most important factor.

Many franchisors stipulate certain parameters for determining whether a site is acceptable, including:

Distance from other franchisees

Store footprint

Demographic factors:

- Size of community
- Number of households
- Average household income

Distance from competitors

Tenant mix

A franchisee will then need to decide what's most important to them and what kinds of trade-offs they're willing to make based on their budget and evaluation of sales potential.

JUGGLING ACT: MANAGING ACROSS YOUR LEASES

As your business grows and you're managing multiple locations, it gets harder to track all of your leases and stay on top of key performance indicators (KPIs) across all of your locations. Maintaining everything in an Excel spreadsheet is no longer going to do the trick. For each of your leases, you need to be asking the following questions:

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When are renewal options coming up? Are they at a fixed rate or a market renewal rate?

When are expansion options coming up?

Have you taken advantage of all tenant improvements available to you?

What are the specific relocation clauses?

Are your tax and maintenance bills correct?

Do you have audit rights in your lease?

What are your rights regarding landlord neglect?

In addition, you can't take your eye off of new opportunities. You still need to ensure you're getting the best deal possible when opening new stores, and you may want to consider enlisting a third-party fiduciary advocate to represent your interests and negotiate on your behalf. With proper processes and systems in place, managing multiple leases can move from a headache to a significant contributor to your bottom line.

Keeping an eye on the exit

Whether you're considering a sale in the immediate future or updating your long-term strategic plan, it's important for franchisors and franchisees to understand the key factors that impact market positioning. This includes understanding your sources of competitive value and how to maximize them, quantifying and documenting your opportunities for growth, and staying abreast of the buyer landscape.

ASSESS YOUR CURRENT POSITION AND IDENTIFY RISK FACTORS IMPACTING CURRENT VALUE.

Having a solid understanding of your company's value attributes and constraints makes it easier to remedy shortfalls and enhance value in advance of a capital transaction. Think about the following questions as you formulate a picture of your business.

Strategic

- How relevant is your strategic plan in light of current industry dynamics?
- What KPIs are tracked and incorporated into daily management?
- Are your growth prospects defensible and quantifiable?
- How differentiated is your concept?

Organizational

- Who is your source of strategic direction (owner-operator, CEO, board)?
- How deep is the management team behind the owner?
- What's the status of current franchise agreements (expiration and renewal terms)?
- Is the company currently structured to maximize proceeds?

Services and operations

- How strong is your back office technology and enterprise resource planning (ERP) system?
- How do you manage your labor pool?
- Can your operational unit or corporate department scale with growth?
- Can you effectively manage your capital expenditure and working capital needs?

End-user base (franchisees and customers)

- What's your end-market profile and customer attractiveness?
- Is the franchisor/franchisee relationship productive?
- Are unit economics attractive and provide an adequate return on investment?
- What new territories have you identified for expansion?

CONTINUALLY ASSESS THE BUYER UNIVERSE

Buyers interested in franchisors versus franchisees can be quite different and vary across concepts, but both are very active in today's market.

Many large franchisors, flush with cash themselves, are looking to expand their brand portfolios and service offerings. Private equity groups are aggressively bidding on scalable franchise concepts with attractive recurring cash flow and potential for territory expansion.

Large multiunit franchisees are creating value through operating leverage and lean management entities. Private equity groups have historically avoided investing in franchisees due to higher capital costs and that the control of the brand is primarily in the hands of the franchisor. Now, however, these financial buyers have become active investors in franchisee units, attracted by the cash they generate and new unit growth prospects.

Keeping an eye on the financial investors who attend your industry conferences and meetings is important. Competitive research is also critical. Publicly traded competitors or industry leaders often disclose information regarding acquisition strategy and market trends that can help you better understand the current landscape.

For franchisees looking to sell

Franchisees should look first at other franchisees or the franchisor as potential buyers. In exploring other franchisees, consider whether there's been recent activity or consolidation among any of them. Identify the largest franchisee and determine whether they have the financial capabilities to close a possible transaction. If you think that the franchisor is a potential buyer, look into the number of corporate-owned stores and whether they've ever used a right of first refusal to block a pending transaction of a franchisee. This could be a clue to their overall interest in buying up franchisees that are for sale.

With a booming economy and favorable tax environment, valuations are up, and a number of cash-rich buyers are eager to add assets to their portfolios. Regardless of whether you're still growing your business or considering selling, thinking ahead is the key to maximizing value when the time is right to exit.

Opportunity through technology

Franchising, like every other industry, has felt the seismic changes brought about by digital technology. While there are certainly challenges involved in implementing these technologies, including added cost complexity and security concerns, the paybacks make them worth implementing. Consider just a few of the ways emerging technologies can benefit franchise businesses.

ENHANCING THE CUSTOMER EXPERIENCE

Franchises are using technology in stores in new and exciting ways. Many brands are addressing one of the pain points of the in-store experience — paying the bill — by offering mobile payment apps or roving sales clerks with payments-enabled tablets. Others are looking at the more "fun" options technology can afford, from tablet ordering in restaurants to sizing kiosks in retail establishments.

STREAMLINING SERVICES AND OPERATIONS

Automation can lower payroll costs, reduce errors, and make processes more efficient. For instance, in-store kiosks or online chatbots let customers order items or ask questions with no human intervention.

DEEPENING CUSTOMER RELATIONSHIPS

Social media is allowing brands to reach customers where they increasingly live — online. Ongoing engagement is now possible, and even expected and desired, from a company's most loyal customers. Customers who sign up for special offers are by definition willing to share some level of personal information — all data that can be fed into sophisticated data analytics platforms. Personal information can also be used to tailor special offers to individual preferences.

CREATING "JUST-IN-TIME" MARKETING OPPORTUNITIES

Mobile beacons and location-monitoring technologies allow businesses to increase sales by sending smart alerts, coupons, or other special offers to customers who are in the vicinity of their stores.

EXTENDING THE BORDERS OF THE ENTERPRISE

Technology advancements have seen the rapid growth of mobile pop-up stores. Some franchises, recognizing this as a relatively low-cost opportunity to broaden their reach, are embracing this marketing tactic as a way to introduce their offerings to customers in areas where there are no brick-and-mortar stores. This is also an excellent way to test the viability of a new store location.

These opportunities are just the tip of the iceberg. As technologies become more sophisticated and customers become more demanding, it'll be hard to envision running a business without technology.

Talent: It's all about fit

It's no secret that talent is central to a smoothly run operation and ultimately to a brand's success. Franchises are no exception, yet they face some additional challenges when it comes to ensuring the right people are in the driver's seat. That's because, although each location is a separate business, each needs to operate in a manner that conveys a consistent brand message and customer service — and much of that is communicated through people. Following are some key ways to get the right talent in the door:

INSIST ON EXPERTISE.

It's important that the people brought in to run an individual franchise not only understand the specifics of franchising, but also have a familiarity with the industry in which the franchise operates, whether it's hospitality, auto parts, or fitness.

USE THE BRAND'S VISION AND MISSION TO BUILD A TEAM.

The brand will thrive when everyone is working from the same playbook. A clearly articulated vision and mission can serve as a kind of "shorthand" for teams so that they can operate together seamlessly to move the entity forward.

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LOOK FOR CULTURAL COMPATIBILITY.

Every franchise has a unique culture. Culture permeates everything from work-style behaviors to reward structures, and it's central to delivering the brand promise to customers. When individuals come on board who are at odds with that culture, it can affect the entire brand. Using personality assessments and interviews that focus on work-style behaviors and "fit" can help ensure that new hires are the right hires.

TRANSLATE YOUR BRAND INTO BEHAVIORS.

Successful franchises have distinctive "personas" that are communicated from the top down. It's important to understand what customers want and then link this to specific behaviors. Standards around these behaviors can then be built into onboarding materials and employee training.

ARTICULATE WHAT SUCCESS LOOKS LIKE.

When employees understand what it takes to succeed, they're far more likely to set their sights in that direction. By identifying developmental milestones and being explicit about what it will take to get to the next level, staff know what's expected and can chart their path accordingly.

Tax-planning considerations

Taxation is a critical issue for any company, and tax structuring is likely to change as your business grows. The sweeping changes to tax law that went into effect in 2018 make it more important than ever for franchisees and franchisors to review their tax-planning strategies. Companies can realize significant tax benefits in a few key areas.

STATE AND LOCAL TAXES (SALT)

When most franchises start out, their corporate presence is restricted to a single location or state. But as the business grows, it may expand both within the state and in other jurisdictions. Expansion can take the form of physical stores or locations where products or services are sold to the public, or it may involve sending sales people to a neighboring state to solicit new franchisees.

In either case, if your business is expanding, your state and local tax (SALT) exposure and liabilities may change — in some cases, dramatically and unexpectedly. Even without a physical presence (office) in a neighboring state, a sales team's activities there may create a taxable presence. In certain instances, you may find that you are taxed in excess of 100 percent of profits, clearly an undesirable consequence and one that can (and should) factor into your growth strategy.

Nexus determinations

The first step to assessing tax liability is determining nexus. Nexus is what a state considers to be a taxable presence within their state. For a franchisee opening a store or restaurant in a state, nexus is clear, and state tax liability is well understood. However, take the case of a franchisor whose sole corporate office is in its home state. Other states may rule that nexus is established for that franchisor as long as it has franchisees located in that state.

A multistate business may therefore unknowingly be exposed to tax liability with substantial tax consequences. Furthermore, the countdown for the statute of limitations will not begin for a taxpayer that has established nexus but failed to file a tax return. In other words, the state has the right to reach back for all years in which a state filing was not made. In such instances, a voluntary disclosure agreement (VDA) may be available to allow the taxpayer to remit past-due taxes without penalty.

Apportionment considerations

Analysis of apportionment rules in a multistate environment can result in tax consequences that are favorable to a taxpayer. Differing state requirements sometimes result in situations where less than 100 percent of activity is taxed at the state level.

Sales and use taxes

The sales tax environment has been significantly altered with the Supreme Court decision in the Wayfair case in June 2018. A review of new sales and use tax requirements as a result of Wayfair can identify exposures that didn't exist prior to 2018, and mitigate them through the VDA process.

Final considerations

Any franchisor or franchisee considering or taking part in multistate activity should review its operations to assess its tax exposure and potential liability while exploring opportunities for "nowhere" apportionment. With varying rules for nexus and apportionment in each state, it's essential to understand the distinctions and build a growth strategy accordingly.

TAX CREDITS

There are a number of tax credits available to franchisees that are often overlooked. Two of the most important are the work opportunity tax credit (WOTC) and the FICA tip credit, which is pertinent to restaurant franchises.

WOTC reduces income taxes for companies that hire employees from certain targeted groups such as financial aid recipients, qualified veterans, qualified ex-felons, or the disabled. Generally, WOTC is calculated based on wages that cover services rendered during the one-year period starting on the day the employee begins work. The credit is valid for qualified individuals who begin work on or before Dec. 31, 2019. After Jan. 1, 2020, this credit expires, so businesses are encouraged to take advantage of it while they can.

Businesses that employ workers who earn tips can claim a credit against their federal income tax based on the share of FICA and Medicare taxes they pay on employees' reported tip income. The calculation is a bit more complicated than simply multiplying reported tips by the FICA percentage. Taxes are reduced based on what are known as "creditable tips." The FICA tip credit is included on the General Business Tax Credit (GBTC) portion of the employer's tax return. Because it's not a refundable credit, it can't reduce a tax liability below $0. However, any unused portion of the credit can be carried forward and applied to future tax returns.

ACCOUNTING METHODS

Many new businesses choose cash basis accounting, rather than accrual basis. The former is generally easier to track and understand since the company pays tax on income when it's received. The cash basis method is tied to cash flow without regard to accounts receivable and accounts payable.

As a company grows, the accrual basis offers a more precise view of long-term financial health. It may also offer appealing tax advantages, allowing it to defer tax obligations. In prior years, the IRS required many companies to be on accrual method due to restrictive eligibility; however, the Tax Cuts and Jobs Act has raised the threshold. Businesses may now use the cash method of accounting if they have average gross receipts of $25 million or less in the three prior tax years.

Timing is critical when making an accounting method change: You must be able to anticipate when you'll reach the income threshold governing accrual accounting. Even if you fall short of that income level, recognizing what deferral opportunities exist, and being able to successfully convert methodologies, will minimize your tax liabilities.

COST SEGREGATION

Building costs and improvements are a significant component of many franchise businesses. For tax purposes, these costs are generally depreciated over a lengthy 39-year period. However, franchisees can realize the tax benefits of more rapid depreciation by undertaking a cost segregation study. Cost segregation identifies personal property that can be depreciated over a variety of shorter recovery periods utilizing accelerated depreciation.

Improvements to a facility that are not necessary for general building use often have shorter depreciation lives. These might include portions of plumbing, electrical wiring, mechanical systems, finishes such as carpeting or flooring and certain types of equipment. Land improvements may also qualify, including such items as parking lots, sidewalks, light poles, and storm sewers.

> For example, if a franchisee builds out space in an existing building with a construction spend of $1 million, a cost segregation study will result in approximately $100,000 in first-year savings, assuming a 6 percent discount rate and a 40 percent composite tax rate.

A cost segregation study can be performed during the year a franchise is being constructed or remodeled. This allows the franchisee or franchisor to immediately optimize tax savings and accurately classify assets. But post-construction is not too late: IRS Form 3115, Application for Change in Accounting Method, makes it easy to go back and claim missed depreciation on assets acquired as far back as 1987 without amending prior tax returns.

Adopting the new revenue recognition standard

Implementation of the new principles-based revenue recognition standard is in effect for publicly traded companies, while nonpublic entities are still making preparations for the required 2019 implementation. There's still time to learn from the experience of franchises that have already made the transition.

GET ORGANIZED.

The new ASC 606 requires an extensive inventory of contracts and close examination of relevant terms. It can be time-consuming to identify all of the obligations owed to each franchisee, especially if contract terms vary. Start by grouping similar agreements and identifying agreement-specific terms that could result in unique forms of revenue recognition. Segregating outliers can make it easier to apply the new revenue recognition rules to the more homogenous group of contracts and terms.

ADDRESS HUMAN CAPITAL NEEDS.

During the transition, people in your organization with specialized knowledge about institutionalized processes, systems, and procedures could be short on time. Consider adding temporary staff with the skills to perform administrative activities that your implementation team may not have time to address. Lightening the load for your core team will make the transition process run much more smoothly.

There's still time to learn from the experience of franchises that have already made the transition.

FOCUS ON DOCUMENTATION.

Franchisors must understand and quantify the changes to their balance sheets and income statements as a result of applying the rules. Even where those changes are not significant, the new disclosure requirements mean that additional analysis and new information is needed. A major distinction between the new principles-based standard and the previous rules-based standard lies in the supporting documentation. Developing and maintaining comprehensive documentation throughout the process will avoid a lengthy catchup exercise near the end. It also helps to review the additional disclosures made by franchisors who were early adopters to determine whether your planned disclosures are in line with others in the industry.

UNDERSTAND THE TIME REQUIREMENTS.

Financial statements need to change at the beginning of the period for which you're adopting the new standard. It could take a long time to finalize necessary changes to processes and systems and get the right data into the financial statements. Restating prior periods can add even more time to the process. Ensure that system revisions are online at the beginning of the year to uncover any challenges to reporting the information needed for the first full set of financial statements. If you're planning to restate prior periods, start your process even sooner. Performing a "dry run" of the closing process is a great way to confirm that you're ready to go live.

COMMUNICATE WITH STAKEHOLDERS.

The impact of the timing and amount of your revenue will vary depending on whether you're a franchisor or franchisee. You'll still need to disclose important decisions, as well as the methods and analysis used to produce the revenue presented in your financials. Your financial statements will look different to you and your readers. In the new principles-based rules for revenue recognition, the focus will be on explaining how you arrived at a number, rather than on the number itself.

> Could your debt covenants be affected by the change? If so, you should contact your bank and work with them to make sure that those covenants are reset upon implementation.

The more you can prepare financial statement users and other stakeholders about the changes ahead, the fewer issues you're likely to have once the new standard has been implemented.

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