Limited-Service, Unlimited Possibilities

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# Fork in the Road [1]

It's an age-old question: Should your brand grow through franchised or company-owned units? For many, the answer isn't so black and white.

Operations ran pretty smoothly when Jeff Osterfeld opened his first Penn Station East Coast Subs in 1985 in downtown Cincinnati, Ohio.

Things got a little dicey after the company founder had opened three stores. He learned that if he was at one store, it would be fine—the food would come out quickly and correctly, the restrooms remained clean—but the other two stores would backslide.

Osterfeld's predicament 30 years ago helped shape what executives at Penn Station now call an "ownership mentality." At the time, Osterfeld needed employees who would feel and act like owners, willing to do whatever it took to succeed.

That's why Penn Station began franchising back then, and it's why the brand still leans heavily on franchised operations; only one of its 295 locations is company-owned. And the brand goes further with the "ownership mentality," requiring a managing owner to oversee each location and tying each general manager's pay to profits and performance evaluations.

"We're a true believer in the franchise model," says Penn Station president Craig Dunaway. "I think that ownership model is so engrained in who we are. I think it's probably why a homeowner takes better care of their home than an apartment renter. We want an owner as close to the counter as possible."

In the age-old debate over whether to expand through franchised or company-owned stores, Penn Station is firmly in the franchise camp.

Although franchising may seem like just a faster and cheaper way to grow, Dunaway says, franchisees with their own capital on the line also care more about the product and profits than a company-hired manager. He adds that the brand is picky about which franchisees it lets in the system.

"I think it's a higher bar [than other brands]. And we hear that from prospective candidates," Dunaway says. "We feel like we kind of know better after 30 years. Ultimately what we're selling is profitability and return on investment."

Franchising, long a popular method of accelerating growth in the quick-service market, shows no signs of slowing down. Up-and-coming brands are increasingly using franchisees to push up unit counts and quickly bring their brands to regional, national, and international audiences, experts say.

In recent years, even legacy brands like Burger King, McDonald's, and Wendy's have made headlines for massive refranchising efforts.

Among the top 500 chain restaurants, 76.4 percent of 2014 unit growth came from franchisees, according to Technomic. The share of franchise growth was up more than 2 percent compared with 2009.

But Technomic's research also showed that heavily franchised brands underperformed compared with company-owned stores in 2014. The 225 majority-franchised chains studied posted a lower-than-average sales increase of 3.2 percent in 2014; the 44 completely franchised brands recorded a collective decrease of 1.6 percent.

Conditions were much better for companies that operated more than half of their own locations, which counted a 5.6 percent collective increase in 2014 sales—higher than the average 4 percent increase for the top 500 as a whole.

The group of 183 chains that included no franchisees posted the highest sales gains in 2014, at 6.2 percent.

Technomic content manager Mark Brandau says data flies in the face of the conventional wisdom that says franchisees are just better at operating restaurants than large corporations. Nevertheless, he does concede that there are plenty of advantages to franchising.

"I think what I bristle at, and what the data don't necessarily confirm, is this notion that a franchisee is always going to automatically outperform a company-owned unit manager, all things being equal,"
Brandau says.

That's one reason several brands are opting against the franchise model. Modmarket, a 13-unit, Colorado-based, health-minded fast casual, is fueling its growth in-house. Save for a single airport franchisee, which was required by the Denver International Airport, all of Modmarket's stores are corporate-owned and operated.

Cofounder and co-CEO Anthony Pigliacampo says he plans to keep it that way. The farm-to-table chain aims to become a national brand with eight new stores planned for 2015 and as many as a dozen in 2016.

Pigliacampo says franchising can be a smart, convenient financial tool to accelerate growth. If Modmarket were a simple sandwich concept, he says, franchising might make sense.

But it is not; the brand is known for scratch-made soups, salads, pizzas, and plates, which are hard to systemize and hand down to a franchisee. The company is also highly mission-focused, believing that the country's food system is broken and that Modmarket is part of the solution.

For those reasons, Pigliacampo says, running company-owned stores allows the brand to maintain control of both its food and its attitude. Strong unit-level economics are important for convincing and selling franchisees, but he says strong numbers are even more important for brands like his that finance their own growth.

"You have to raise all the money yourself," he says. "I think we actually have to operate better than a franchise system in order to maintain the growth rate we've done to date."

And Modmarket has amassed plenty of interest in franchising.

"We could probably do it faster if we were franchising. There's no doubt," Pigliacampo says. "We get multiple inquiries every day. There are some weeks you could fill up an inbox with people wanting to franchise. But for us it's about the quality of what we're doing, and we really value that control we get as a company-owned concept."

For some franchised brands, it's not uncommon for stores to fluctuate between corporate- and franchise-owned. Many larger, older restaurant brands go through cycles of selling and buying back locations from franchisees, as McDonald's and Wendy's have recently done, says Michael Daigle, a partner at Cheng Cohen, a Chicago-based law firm.

"I think franchising is definitely on the upswing," says Daigle, who has worked on franchising issues for major brands like Boston Market and Popeyes. "I think it always has been. But individual brands go through life cycles."

Daigle is a franchising advocate, but says it has to be done correctly. The concept needs to be proven and unit-level economics must be strong in order to franchise.

He adds that choosing the right franchise partners is paramount, which means companies on the verge of franchising need to think in the long term and be picky about whom they let into their system.

"I think one of the biggest mistakes that particularly new franchisors make is not being willing to say no," Daigle says. "It's kind of sexy when someone wants to buy into your brand and pay you a $25,000 or $30,000 franchise fee to be a part of it. It's hard to say no to people who are interested."

Approving or denying franchisees at Dunkin' Donuts is a complex process, since no single department or officer makes the call. Rather, it's a collective courtship process in which potential franchisees are vetted across departments to see whether they're a fit for the brand. Of the more than 11,300 restaurants, only about 40 are company-owned.

Grant Benson, Dunkin's vice president of global franchising and business development, says such a large share of franchised units allows the company to put nearly all of its focus on supporting franchisees.

"What we do best is franchise," Benson says. "And what we do best is support franchisees, making them more profitable, helping those business people meet the goals and objectives they set."

While Dunkin' could look at adding more company units, Benson says, he doesn't want franchisees to feel like corporate is competing for real estate, market share, or the talent pool. He believes it makes sense to stay on one end of the franchising-corporate spectrum or the other.

Still, Dunkin' keeps some presence in company-owned stores, which can act as labs for new products. These stores also allow the brand to test out new markets before franchising in the area. Dunkin' is constantly opening and selling off its rotating stock of company units, Benson says.

“In some ways, it allows us to jumpstart certain markets, for us to go in and establish the first half-dozen in the market,” he says. “They become billboards in the area and give candidates an opportunity to come into the system and not wait a year and a half to build their first store.”

Franchising expert Lynette McKee says restaurants that franchise need to ask themselves a question: Are they a restaurant company that franchises to grow or are they a franchising company that uses the restaurant industry as a growth vehicle?

McKee thinks they should adopt the latter attitude. As the CEO and managing partner of McKeeCo Services, she has more than 20 years of experience in franchise development and strategy with major legacy brands like Dunkin’, Burger King, and Checkers.

“Your franchisees are your customers,” she says. “As long as your customers are thriving and happy, they’re going to take care of ... the end users and customers of the restaurant.”

McKee is a proponent of franchising. She thinks smaller groups can maintain quality easier than a giant corporation, and franchise-heavy brands do not need as much overhead.

While it’s common for tensions to sometimes run high between franchisees and franchisors, McKee says, brands can learn a lot from those franchisees operating on the ground.

“If you are partnering with good, experienced operators, the old saying is they have the best ideas and they have the worst ideas,” she says. “And your job is to differentiate between the two.”

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