

Microeconomic Aspects of Franchising

Jozef Orgonáš¹

Abstract

The present arrangement of franchising is a very popular business form. It is a very dynamic form of making business. The form is very modern and conservative at once. It's modern enough and at the same time approved, to represent the possible visionary way of the entrepreneurship in the 21st century. Franchising has become a means of growth across many different industries, including business and financial services, beauty, health, sport, various services, food, medical, recreation and many others. Our effort might understand how the franchising performance drivers applied in the microeconomic parts work and how important it is for franchisor and the franchisee, as well.

Key words

Franchising, Microeconomy, Break-even point

JEL Classification: M 31

Received: 25.3.2020 Accepted: 24.6.2020

Preface

Franchising is a specific form of business, which has begun with development in the 50th of last century, whereby the noticeable dynamics gained at the end of last two decades of the 20th century. Its specific substance wins by offering of attractive possibilities for small and medium sized enterprises by effectivity, lifetime stability in first five years of business activities and its positive vision for survival in the period of crisis and turbulent time. The successfulness of entrepreneurship by franchising form is one of the safety forms of entrepreneurial activity. It offers anyway the rational format with clearly divided tasks, which is the base of dynamical and effective system, at which its compactness, integrity, and reliability is the precondition of surviving and achieving of success, for both parties — the franchisor and for franchisee, as well. Franchising is model for small and medium sized enterprises, which works well if both sides become integrated with it.

Franchising is fascinating business area and one that has served those well who have been involved with ethical and responsible franchising operations. The franchising philosophy is that it is a great method whereby those who have experienced and been successful in a structured business environment, and who would love to satisfy the dream of self-employment, are able to do so but with the safety net of having the organizational structure of the franchisor behind them to give advice and guidance as they realize the dream and move forward to self-employed success (Weber, 2013).

¹ Ing. Jozef Orgonáš, PhD., University of Economics in Bratislava, Department of Marketing, Dolnozemska cesta č. 1, Bratislava; Slovak Republic, e-mail: jozef.orgonas@euba.sk

1 Methods

The aim of the paper is to point out how important, as the form of making business, the franchising is and how important are the microeconomic aspects of this business, including the break-even point. We used the method of collection various definition of franchising, we analysed them and by synthesis of most important elements of franchising system we proposed own definition of franchising.

2 Results and Discussion

Franchising belongs to vertical marketing systems. The conventional marketing channel consists of independent producer, wholesaler and retailer. Every of them is the independent company, aspiring on the maximization of the own profit, even when such activity leads to less profit for the system, as unit. Nobody of members of the marketing channel has fully control over the other chain members. The vertical marketing system integrates the producers, wholesalers and retailers, they may figure as the connected system. One of the members of the channel owns the other members or dispatches by such power, that he may make the other to the cooperation. The vertical marketing system we split to three types: the corporate system, the administrative system and the contractual one (Kotler – Keller, 2013). In the practice we know many definitions, pseudo-definitions, various formulations, they specify the core of the franchising. We are presenting some of them, it could be seen the variety of the authors, finally we state our own definition:

1. Franchising is a system of marketing goods and/or services and/or technology, which is based upon a close and ongoing collaboration between legally and financially separate and independent undertakings, the franchisor and its individual franchisees, whereby the franchisor grants its individual franchising the right and imposes the obligation, to conduct a business in accordance with the franchisor's concept (European Franchising Federation, 2018).
2. Franchising is a market form, based on the partnership. Franchising picks over for the fees the franchisor's existing concept and transforms it to his own local conditions. It is a legal separate unit, working on own self-profit and on own self-costs (DFV, 2012).
3. Franchising is a contractual agreement by and between two parties, whereby one party (the franchisor) extends the right to the other party (the franchising) to carry on an independent business under the trade mark or trade name or brand of the franchisor and to receive sufficient privileged know-how, derived through the franchisor's experience in operating such a business, throughout the term of the agreement, consisting of all components as to enable a previously inexperienced person to establish a successful business under the franchisor's brand. In consideration for the initial and ongoing assistance from the franchisor, the franchising commits to substantially invest in his own business and to a scheme of payments in the form of initial and ongoing fees. The franchising further undertakes to use his best endeavours to ensure the success of the franchisor's brand and to adhere to the franchising system, following the guidance of the Franchisor to mutual benefit (Weber, 2013).

4. We tend to delineate the franchising term, as follow: *Franchising is a vertical marketing system, certified by a provider who on a contractual basis provides comprehensive concept, including know-how, licenses including training, continuous education and trademark to a legally and economically independent beneficiary, for a charge.*

If we try to recapitulate, we could say, that franchising is a business format; franchising is a type of commercial relationship based on a contractual agreement between two independent business parties, the franchisor (the seller of the business proposition) and the franchising (the buyer of the business proposition), in which the franchisor grants the franchising, for the term of the contract, the right to buy and operate the franchisor’s branded and formatted business system for a fee and according to the prescribed rules and procedures developed for the system by the franchisor (EFF, 2018).

Scheme 1 The Phase of Franchising Chain Creation

Entrepreneurial conception	<ul style="list-style-type: none"> • Group of specific products, services and patented technologies, • trademark, mark of services, commerce name, sign, symbol, logo, licence • ownership and using know-how, patents and contrivances.
Model (pilot) operation	<ul style="list-style-type: none"> • European Code of Franchising: it’s necessary to verify the fruitfulness of the concept; before establishment into the net, at least in on shop for minimally the period of 1 year.
Head office	<ul style="list-style-type: none"> • "head" fo the system; the head-quarters carries out the task with the franchisees.
Franchising package	<ul style="list-style-type: none"> • body of laws and performances, the franchisor offer the franchisee, the core of franchising.
Choice of franchisees	<ul style="list-style-type: none"> • the choice is realized by personalities of franchisees, financial situation, material terms and the aimf of the franchisor.
Franchising fees	<ul style="list-style-type: none"> • access (initial) fee, acitivity charge, specific fees and the charges for common advertising.
Franchising agreement	<ul style="list-style-type: none"> • precontractual phase (culpa in contrahendo), • franchising contract is longterm agreement, usually 3 – 5 years.
Expansion of franchising chain abroad	<ul style="list-style-type: none"> • the possible forms of accession on foreign markets: direct or indirect export, joint venture, co-branding, masterFranchising and others.

Source: Own elaboration, Orgonáš, 2017

In the new global economy, franchisees can be seen as important players in economic development. The reasons for their significance are their contributions to job creation (which increases employment) and economic growth at the regional, national levels (Petrů – Pavlák – Polák, 2019). Looking for right application of franchising form of business, the franchisor has to create a complete model, with the entrepreneurial conception, model operations, head office, the comprehensive franchising package, and potential expansion abroad, as seen from the scheme 1.

Standardizing routines allows the franchisor to replicate existing sources of competency throughout the chain (Kistruck – Webb – Sutter – Ireland, 2011). But before he has to apply the franchising package to his franchisees on national, home market. In the market economy is the risk of enterprise the ingredient of the system. The certain entrepreneurial risk of the implementation and the launch of franchising concept and the system to the market. The measure of the risk is possible to optimize by consistent systematic approach, what dispatches or eliminates the potential risk or the causes. Every franchising concept is realised in concrete time and space. This fact is necessary to make provision for the alignment of right term of the entry of the concept to certain territory (on new market).

Forms of Franchising

Franchising we may sectionalize according various criteria, most know are manufacture franchising, distribution franchising and franchising of the services. Franchising falls into six (or in the practice more) segments, as follow according to (Weber, 2013):

1. Retail – supermarkets, self-service market, clothes, article of electro, footwear, furniture, accessories.
2. services at real estate, cleaning, maintenance, design, decoration, repair.
3. personal services – fitness, beauty salons, education, tourist offices and others.
4. commerce and communication services – professional and financial services, personal agencies, schooling, IT and communication.
5. hotel and catering services – hotels, bars, commercial and industry procurement.
6. transport – hire services, repair and maintenance services, courier services and others.

In a general proves the advantage effect, if on concrete area and on concrete time happens hence of the demand for some product. In this case the advantage has that licensor, who comes earlier. The adjusting of the right time of the opening (if is it possible to influence) is valid, of course, for each shop of the franchisees. It is necessary to make provision for the seasonality of the actual segment of the business and the status of competitive environment on special-interest area. To adopt the right decision about the range of the franchising concept is it needful to dispose the complex of information about the concept. The provider of franchising licence gives it at disposal normally only

on base of ex ante restricted treaty about the secretiveness, the treaty about the hold-back of business secrets. The licence provider condition for such treaty is modular and eligible. The effectual franchising draft, its know-how, is intellectual property of the licensor, has the price and the value potential. Its possible derealisation of abuse may cause the provider the detriment or profit loss. It is anticipated by defence of intellectual property. The contract issue about the discreetness is at the same moment the test for future person interested about the franchising licence buying. If the interest is genuine and serious, it hadn't be any problem to fix a contract with the sanction conditions for infringement, as well. If the buyer interest is serious, it doesn't come to any contract break. From this point of view and own experience we may confirm that all preparatory proceedings are very important. The basic aim of the business is the profit creation. The same is applicable to franchising. The interested person for franchising licence buying, before the decree, are entitled to win from the provider the information, verified in the praxis about the economic conditions of making business. As model is the pilot shop of licence provider. As commercial interest may be considered such franchising concept, that makes a successful business in one year (at least). The 12 months surface the possible seasonable, operational and economic variations. The franchisor is compulsory to offer the person of interest for franchising buying an overview of economic figures on the results of the business of the pilot shop, including the overview of complete costs. They are the fundament, that the buyer uses at calculation of expected economic results of his future franchising shop floor, at calculation of return of investment for the equipment and for construction of complete business plan. The real yield test and the measure of economic effectivity of the know-how in the pilot shop, serves for calculation of moderate franchising and licence fees. The fair regulate of them sets up the precondition for long-term and stabile commerce relationship between the provider – franchisor and the user franchisee (Orgonáš et al., 2020).

Franchising is in current period of development an important economical category and plays a significant role in the whole world economy. So, as other branches, it has an eminent interest to expand, either by extending of own activities on home market, or by enlarging of the portfolio or by expansion to foreign market. The motivation varies, but it concerns the reconnoitre of widening of market opportunities, increasing of profit, enlarging of the market share or expansion of the mark. The technical tools and tactical instruments are various, beginning with simple export until the establishment of international nets, whereby a part of such possibilities relates directly with franchising. It's a traditional form of entrepreneurship, in last year ever more presented. Franchising is the element of retail, wholesale and services. The retail activities, incl. the franchising activities (remark of the author), not only on European market, were in last decades stigmatized by these development tendencies, they eventuated in many important changes (Patriche, 2000):

- the concentration and cooperation – increasing of the number of large companies and the vertical connection among the producers and the mediator
- the transformation – the reaction on the disparity among the countries, the expansion of the franchising concepts and the development of add-on sale
- the diversification - the enlargement of the activities via the participation in various sectors
- the internalisation – the orientation on the markets of other countries.

2.1 The Costs and Revenues

In the microeconomic context with franchising we are thinking notably on these microeconomic aspects (Orgonáš, 2020):

- profit,
- costs,
- financing,
- human resources,
- company decision about "4 P" (the basic marketing mix: product, price, place, promotion),
- standardization.

The basic aim is to reach the profit, which is the most important indicator. The direct impact on the aim will have the costs and revenues. Simplified we could divide them as follow (Orgonáš, 2017):

Revenues:

- revenue from products sales,
- other incomes,
- extraordinary revenues.

Costs:

- material costs,
- staff costs,
- personal costs,
- costs overhead,
- interest, taxes and other fees.

The financing need not only the franchisor. His duty is to facilitate the financing for the franchisee, or to help him at financing winning. The costs of planning and the conception to carry the franchisor. To his costs we may add the costs for schooling, trainee development, the handling of "franchising bible", marketing and communication strategies. The practice confirm that the successful entrepreneurs have ability push the system on national level and on international level, as well. For system financing they use own financial resources, the foreign (bank) finances, very often "pro rata temporis".

If we would like to arrange the finances for establishment of the franchising concept, we have differentiation among (Flohr, 1994):

- investment
- the specific tasks of the system building
- beginning drop-out
- the liquidity reserves

They are other elements at franchising concept financing, they are needful to be followed such as:

- fix costs:
 - staff costs
 - fire costs
 - leasing rates
 - insurance and other fees
 - agreement services
 - finance costs
 - other long time period costs
- variable costs:
 - added goods orders
 - advertising costs
 - taxes payed in advance
 - working out of application manual
 - basic documents for schooling and training
 - initial product prices
- other payment duties:
 - borrowing finances
 - payment on the thirds
 - own enterprise needs
 - private needs
 - salary
 - exhaustion and interests of the credits

The generated profit is identifiable indicator of successfulness of the entrepreneurial subject in franchising. It forms the preconditions for next company development. The critical point is the financing. For preparing, developing and realization of every franchising concept is capital needed. The franchising creator need calculate with investment. The first input cost is, f. e., the purchase of franchising licence. Next costs are the investment for creation of franchising concept, franchising operations, secretarial capacity, software, goods and others. It is necessary to calculate everything. As the sources for financing they are preferred the private sources because they are most safe, in relation to the risk optimizing of next business. It's possible to utilise the leasing (purchase of the technology, car, devices etc.), or credits. The new companies have however the problem to win the credit for the reason they have no „history“ and the banks are mostly not ready to undergo the risk together with the Franchising creator (Šétaffy, 2016).

2.2 The Break-even Point

The definition of break-even point, in accounting, refers to the revenues necessary to cover a company's total amount of fixed and variable expenses, and other payment duties, during a specified period of time. In other view the break-even point is the performance level where total revenues equals total expenses. Or, the break-even point is

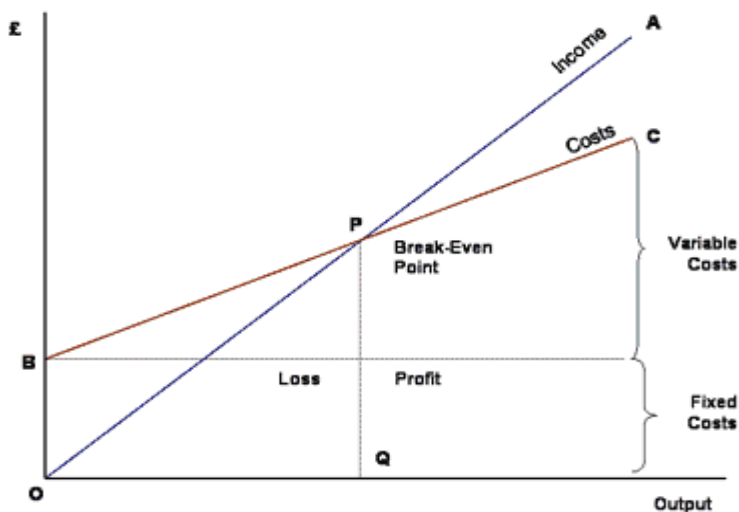
where a company produces the same amount of revenues as expenses either during a manufacturing process or an accounting period.

For many businesses, growth often means a physical expansion of an existing store or the opening of additional stores. Is it worth the cost? There are two parts to the answer: finance and marketing. The financial analysis answers the question, *"What do we need?"* The marketing analysis answers the question, *"What will we get?"* To get our arms around the analysis requires an extension of my "break-even" discussion in the previous issue.

Let's look at how the franchisors do it. Suppose a large quick-serve franchising is looking at a new location. By knowing accurately their fixed and variable costs, they can calculate a break-even sales volume level. With thousands of existing outlets to use as models, they know their costs to the penny, exactly what they need to invest, and their target return on investment. They can then calculate the required profit. Then, considering the target profit as "fixed" (the cost of money) they can easily calculate the required sales to cover the costs and supply the necessary profits--and the answer to the question, *"What do we need?"*

At the same time, the marketing folks analyse the target market area so they can accurately predict sales, or *"How much will we get?"* Next, the marketing and finance people put the puzzle together. If what they will get is greater than what they need, it's a go. The other way around, and it's a no-go.

Scheme 2 Break-even Point



Source: Internet, google.com/search

Admittedly, the process isn't perfect, and the risks are several: only doing half the analysis, being wrong anyway, and not evaluating whether the growth is accomplished

at the expense of increasing levels of debt. Nevertheless, the process is better than proceeding blindly; sometimes it's most useful in predicting what won't work, rather than what will. Who can use this expansion analysis process? Anyone. It is a duty of every franchisor to make a break-even point analysis with his franchisee. For any kind of growth, be it expansion of an existing location or the opening of additional locations. A sales analysis is only half the story. An accurate knowledge of your costs and how they behave is really "the rest of the story" (Orgonáš, 2020).

Conclusion

Many people are asking if right nowadays, in the 21st century, is the appropriate time to begin to be in business. If yes, which form is to be used? There are number of companies and entrepreneurs are not able to be competitive and are looking for the space where to live out or secure the growth. The response may be franchising (Orgonáš – Rehák, 2020). Franchising is a modern form of entrepreneurship going in last year through the renaissance. It's relative safe form of commerce activities, especially in the time of crisis. The compactness, integrity and reliability of the system are preconditions of living through and reaching the success. It brings the advantages for both sides of this contractual relation. It brings the business possibilities. We suppose franchising entrepreneurship creates in this century one of the bearing wall of the entrepreneur activities, it will generate new employment and adds to the stabilization of SME in commerce sector, services and tourism. Franchising has ability to adopt quickly the market demands and belongs to them, they are responding on consumer real needs (Orgonáš, 2020). Franchising brings the great opportunities for franchisees and the franchisors, whereby they both benefit from the franchising concept. The enigma of franchising is a correct cooperation between the franchisor and the franchisee, leading to consistent partnership, knowing all aspects of franchising, especially the microeconomic one.

European Franchise Federation (EFF, 2011) engaged with the franchising position (from microeconomic point of view) in current period. It is assumed that in this century, franchising will be the vector of growth of economic activities:

1. Franchising in Europe has proven to promote the creation of enterprises and small-business ownership, employment and of turnover.
2. Franchising with its business-format rationale, its specified roles and responsibilities of franchisor and franchisee respectively, the transfer of know-how from franchisor to franchisee, and the built-in two-way communication, is a dynamic and efficient system for enterprise growth.
3. It is also an entry vehicle to self-employment for many segments of the work force, including people who want to re-orientate their working lives and who do not necessarily have prior entrepreneurial experience.
4. A proper franchise system ensures the continuing provision of commercial and technical assistance throughout the term of the contract and thus truly increases the survivability rate of start-ups as well as their sustainable growth, particularly in times of crisis as the circumstances of the latest crisis has shown.
5. Franchising is a mode of business development both at local/domestic level where it generates enterprise creation, employment, and wealth as well as at

- international level. At this level, it is a natural vector for the export of business and for cross-border trade, as well as a venue for incoming foreign investment.
6. Franchising contributes to the transformation, modernization, and professionalization of traditional trades and services as well as the formatting of new trades and services. It also professionalises and renders transparent significant portions of the informal retail and service sectors, both in terms of employment and tax benefits.
 7. Franchising, through the in-house training programs for franchisees, and often of their staff, promotes the learning of entrepreneurship as witnessed by the many examples of organic growth stemming from franchisee staff members eventually becoming franchisees themselves.
 8. Franchising promotes best practice and healthy competition between franchise networks (inter-brand competition).
 9. A franchise contract contains vertical restrictions to protect the franchise know-how, identity, and brand image on which everyone in the network depends.

References

- DFV (2012). *Franchising – Ratgeber 2012/2013*. Berlin 2012, 144 p.
- EFF (2018). *Franchising: definition & description*. Brussels, Retrieved February 15, 2018, from <http://www.eff-Franchising.com/101/Franchising-definition-description.html>
- EFF (2011). *Franchising – a vector for economic growth in Europe*. Brusel 2011, 6 p.
- Flohr, E. (1994). *Franchise – Handbuch*. Berlin: Verlag Die Wirtschaft.
- Kistruck, G. M., Webb, J. W., Sutter, Ch, J., & Ireland, R. D., (2011). Waco, TX., USA: Microfranchising in Base-of-the-Pyramid Markets: Institutional, Challenges and Adaptations to the Franchise Model. 29 p. Baylor University
- Kotler, P., & Keller, K. L. (2013). *Marketing management*. Praha: Grada Publishing, 14. vydání, 2013. 814 p.
- Orgonáš, J. et al., (2020). *Franchising in v 4 countries*. Uherské Hradiště, 2020. 248 p.
- Orgonáš, J. (2020). *The Macro- and Microeconomic Dimensions of Franchising*. Uherské Hradiště, 2020. MBA final thesis. 44 p.
- Orgonáš, J. (2017). *The Compendium of Franchising*. Bratislava: Wolters Kluwer. 184 p.
- Orgonáš, J., & Reháč, R. (2020). Franchising – Paradigm of the Enterprise in the 21st Century. New York: David Publishing Company. *Management Studies*, 8.
- Patriche, D. (2000). *Commerce and Development*. Bucharest: Europa Nova, 2000. 352 p.
- Petrů, N., Pavlák, M., & Polák, J. (2019). Factors impacting start up sustainability in the Czech Republic. *Innovative Marketing*, 15(3), pp. 1-15.
- Šétaffy, J. (2016). *Good idea? Franchising*. Bratislava: SFA, 88 p.
- Weber, R. (2013). *An Introduction to Franchising*. Basingstoke: Palgrave MacMillan. 288 p.