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Mark Siebert: Franchising Your Business

A Bad Economy May Benefit Franchises

Learn what drives franchise sales, even in a slowing economy.
By Mark Siebert | November 20, 2008

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With all the negativity making headlines these days, it's difficult sometimes to maintain perspective.

Foreclosures at record highs. Nearly a trillion dollars in bailouts. The Dow with record declines. Mass layoffs and unemployment at five-year highs. Reading Dickens--it was the best of times, it was the worst of times...the period was so far like the present period--it seems that perhaps he only got it half right.

But for franchisors, truer words were never spoken. Yes, there are some short-term difficulties that will take time to flush through the system. At the same time, however, there are a number of reasons to anticipate that the best of times are right around the corner.

Perhaps the best place to gain this perspective is by understanding what drives franchise sales.

There are, of course, thousands of factors that drive franchise sales at the micro level. A bad day at the office. An overbearing boss. A neighbor's franchise success story--and perhaps his new Mercedes. A cancelled flight that leads to the missed soccer game.

But at a macro level, there are three predictable factors that can lead to a surge in franchise sales activity--and many of them are pointing to a franchise boom on the horizon.

The first and foremost factor affecting franchise sales is a rising unemployment rate and the fear of losing one's job. At 6.1 percent, the unemployment rate has increased by 1.4 percent in the last 12 months alone--adding 2.2 million people to the ranks of the unemployed. And some economists are predicting that it will hit 7 percent before it turns around.

While that news is terrible for the economy, and it sounds callous to even mention it, what this means for franchisors is a larger pool of franchise candidates.

Every 0.1 percent increase in the unemployment rate adds another 150,000 prospective franchise buyers to the marketplace. As these newly unemployed hit the market, many will dutifully send out resumes and try to network their way into a position.

But for many, the sad truth is that they will never be able to replace their past level of income by working for someone else. After a few months of futility, many of these formerly employed will realize that the only way that they can hope to match their past salary will be to start a business of their own. And often, they will want the proven systems and support that franchising provides.

Consider mass layoffs, a statistic that represents companies that have more than 50 reported claims for unemployment insurance and is kept by the Bureau of Labor Statistics. These mass layoffs come from the country's biggest companies. And it's precisely these companies that are most likely to provide their employees with some type of severance package that

could fund their initial venture into business ownership.

According to the BLS, September mass layoffs alone added 235,681 to the unemployment rolls in 2,269 mass layoff events, the most since September 2001. Since the beginning of the year, 14,811 mass layoff events have added more than 1.5 million to the ranks of the unemployed, the highest number since 2002. And these numbers don't count those that take an early retirement with a nice severance package. If these trends continue, there may be another million prospective franchisees entering the market before things get better on the employment front.

Even those employees that are left behind are more likely to jump ship--or plan for it in the near future. As these "near layoffs" see their friends and relatives heading for the unemployment lines, they become increasingly concerned about their own job security. And in the process, many will recognize that the only way to be in control of their own destiny is through business ownership.

The second major factor affecting franchise sales is the stock market. Again, bad news for the economy can mean good news for franchisors. During the days of the internet bubble, franchise salespeople often found it difficult to pry people's money out of the market. And with good reason--many investors, seeing spectacular (if speculative) returns in the market, figured in a what-goes-up-must-keep-going-up-forever mentality that all they had to do was hold on to their shares of Amazon, and they could retire millionaires in a few months. When the bubble burst, money flew out of the market--and, in many instances, into franchises.

Today's market has seen similar flights to cash. Many investors have already fled the market, and there may be more to come. Those sitting on the sidelines will soon realize they need to put their capital to work. But given the wild gyrations of the stock market and the fear that has driven many away, it seems unlikely that many investors will be jumping back into stocks anytime soon. Again, franchises and small-business ownership offer a potentially high return alternative.

The third driver of franchise sales is credit availability. This is where the current news isn't very positive. The combination of reduced home values, reduced equity and decreased credit availability has forced some buyers to consider less expensive franchises and has driven some out of the market entirely.

But even this bad news is not disastrous--at least for most franchisors. Franchise prospects that once looked at million-dollar investments are still looking for franchises--only they are now looking at investments in the \$500,000 range. And while franchisors with investments in the million-dollar-plus range are feeling the pinch, this "push down" effect is helping to offset the credit crunch for franchisors with smaller investments.

Moreover, even franchisors with large investments are still making franchise sales--and almost all of these new franchise sales are financed.

Yes, credit is tighter. But deals are still getting done. Today's lenders are looking for a better quality borrower. A couple of years ago, lenders would be happy to consider borrowers with FICO scores of 620. In today's market, they require a FICO 680 or better. But bear in mind that the national average credit score is 692.

Today's lenders are also looking for 30 percent equity participation in franchise purchases. Again, several years ago, franchisees could purchase franchises with as little as 10 percent of the equity needed. Banks are also looking more closely at things like non-business collateral, the experience of the prospective franchisee and whether the household will have a secondary income during the business startup.

Even this bad news has a silver lining. First, it means that franchisees qualifying for credit today are less likely to be at risk if their business performs below expectations as it builds a customer base. Second, credit crunches are typically short-term events. In the last year, the Federal Reserve has lowered fund rates from 5.25 percent to 1 percent. Add to that \$700 billion of new funds pumped into the nation's banking system and other various relief measures, and most knowledgeable observers will agree that it is not a question of if but rather how soon credit will start to ease substantially for people looking to invest in small businesses.

Perhaps equally relevant, the tide is likely to turn much more quickly relative to credit than it will for either employment or for renewed confidence in the stock market. Add a dash of pent up demand, and when this happens, the economy will be poised for a franchise explosion. When this might happen is impossible to say, but savvy franchisors are planning now to capitalize on it.

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