Linking Franchise Success with Economic Growth and Net Job Creation

A white paper by Chad Moutray

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Table of Contents

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Introduction

Americans – especially in these challenging economic times when net job creation is at a premium – appreciate the entrepreneur. Part of this is the mystique of the small business owner and the role that mom-and-pop establishments play in communities. But it is also due to the tremendous impact that they have on our local, regional, and national economies. Research shows that firms with less than 500 employees account for half of the nation's real gross domestic product (GDP), employ half of the private sector workforce, and generate around 65 percent of the net new jobs created in the economy since 1993.[2]

Franchised businesses are an essential segment of the larger small business population.[3] In 2007, franchised small businesses were directly responsible for 7.76 million and 1.37 million jobs, respectively, in business format and product distribution franchises. This totals to 9.1 million jobs, or 6.2 percent of the total nonfarm, private sector employment.[4] To illustrate its importance, franchise employment is roughly equivalent to the number of jobs in durable goods manufacturing, and it exceeds the total employment of such major industries as finance and insurance, real estate and rental and leasing, wholesale trade, transportation and warehousing, nondurable goods manufacturing, and information.[5] When indirect employment is included, nearly 18 million Americans are impacted by franchising with overall output of $2.1 trillion stemming from franchising amounting to 9.0 percent of private, nonfarm output.[6]

Entrepreneurs of all sizes will be vital to our economic recovery. While there have been recent positive signs of economic growth, the employment picture remains weak. Small business owners – including franchises – continue to cite access to capital problems as a concern. This paper will discuss many of the recent challenges faced by small business owners, ranging from cyclical worries about sales to the credit struggles which were exacerbated by the unique sources of this particular economic downturn.

Most importantly, however, this paper will highlight how certain entrepreneurial ventures will propel our economy forward in the years to come, providing new sources of economic vitality and employment to our increasingly global marketplace. These high-impact businesses are sources

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[2] SBA (2011), p. 1.
[3] For more information on franchising, including the different types, see Appendix A.
[4] PwC (2011), p. I-6. Note that much of the analysis in this white paper is for business format franchises only.
[5] *Ibid.*
[6] *Ibid.*, p. I-7.

of innovation and growth, and by scaling up rapidly, they provide a firm foundation for future stability (especially for their workers and local economies) and capture our collective attention. These firms span a wide variety of industries and are geographically dispersed around the county.[7] Small franchised businesses are an integral component of the high-impact firm landscape, as this write-up will show. The franchising business model provides the necessary resources for small business owners to scale quickly and achieve long-term success.

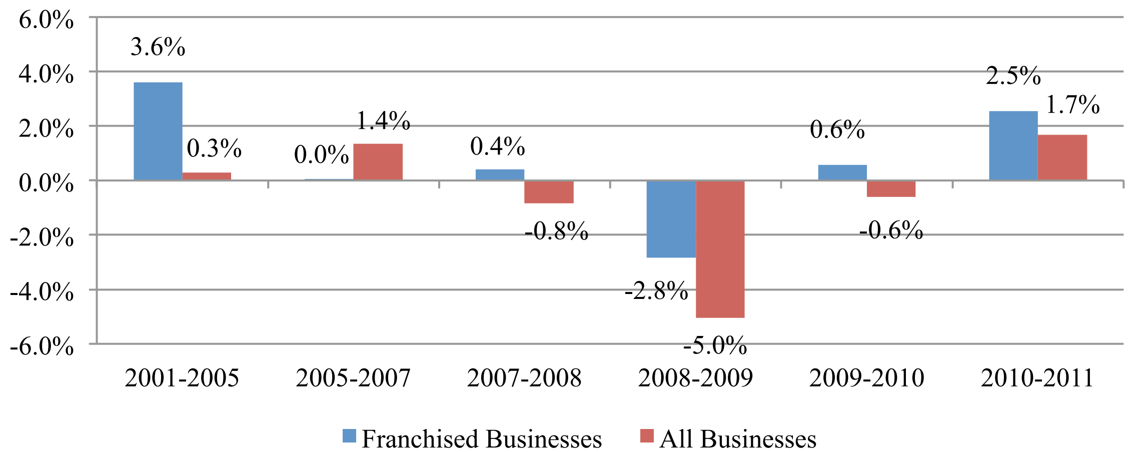
Challenges in the Current Economic Environment

The U.S. economy grew 3.1 percent in the fourth quarter of 2010, with real GDP also increasing 2.8 percent last year, lead by strong growth in personal consumption and net exports. After a rough economic environment the past few years, stronger economic data is a welcome sign. Despite the fact that the recession officially ended in June 2009,[8] economic activity has been plagued by uncertainty and continued weakness, particularly in the labor market. More recently, though, economists have become more optimistic about growth for this year, with demand for goods and services rising, higher capital spending, and positive hiring plans over the coming months.[9] Real GDP is expected to increase by over 3 percent in 2011.[10]

With that said, there are still a number of challenges for small businesses owners. First and foremost, entrepreneurs remain cautiously optimistic about a stronger economic climate. Poor sales remain a major concern for all small businesses, including franchised ones.[11] While small business owners have higher expectations about hiring, capital spending, and sales projections than in previous surveys, economic activity is still below where it should be,[12] and this newer optimism still needs to translate into *actual* hiring and spending activity.

[7] The 2007 Survey of Business Owners from the U.S. Census Bureau received responses from 295 industries, with franchise businesses accounting for 10.5 percent of businesses with paid employees in those industries. For more information, see http://www.census.gov/newsroom/releases/archives/economic_census/cb10-141.html.
[8] The National Bureau of Economic Research has dated the last recession, which began on December 2007, to have ended on June 2009. See http://www.nber.org/cycles/sept2010.html.
[9] NABE (2011).
[10] A number of sources suggest this range for GDP growth this year, including the Congressional Budget Office (3.1%), the Federal Reserve (3.4 to 3.9%), *Kiplinger's* (3.25%), the Office of Management and Budget (3.1%), the National Association for Business Economics (3.3%), the Survey of Professional Forecasters (3.2%), the U.S. Chamber of Commerce (3.2%), and the *Wall Street Journal* (3.5%).
[11] Dunkelberg and Wade (2011), p. 20, and Reynolds (2011a), p. 71.
[12] Joel Popkin and Company (2003) suggests that small businesses remain in a recession whenever the NFIB optimism index falls below 100. This measure has remained below 100 since November 2006, bottoming out at 81 in March 2009. It is currently at 94.5 (February 2011).

Figure 1: Growth in Employment for Franchise Establishments and All Business Establishments, 2001-2011



Source: PwC (2008, 2011a, b); Inforum.
Note: The annual growth rates for all businesses include all private sector businesses in the United States and are not limited to those in franchise business format lines.

Sluggish employment growth will be a challenge for some time. Even with positive growth over much of the past year, there remain 7.5 million nonfarm payroll jobs fewer today than at the end of 2007, and the unemployment rate remains around 9 percent. With stubbornly high unemployment, many policymakers have recognized the importance of small businesses for net job creation as a means of closing the "jobs deficit." On September 27, 2010, the President signed the Small Business Jobs Act, which increased SBA lending limits, included new tax provisions, promoted exporting, and established a new small business lending fund.[13] Indeed, much of the impetus for the legislation and other policy moves has been to spur new hiring among small businesses, which traditionally have begun hiring sooner than their larger counterparts post-recession, but have not done so this time.

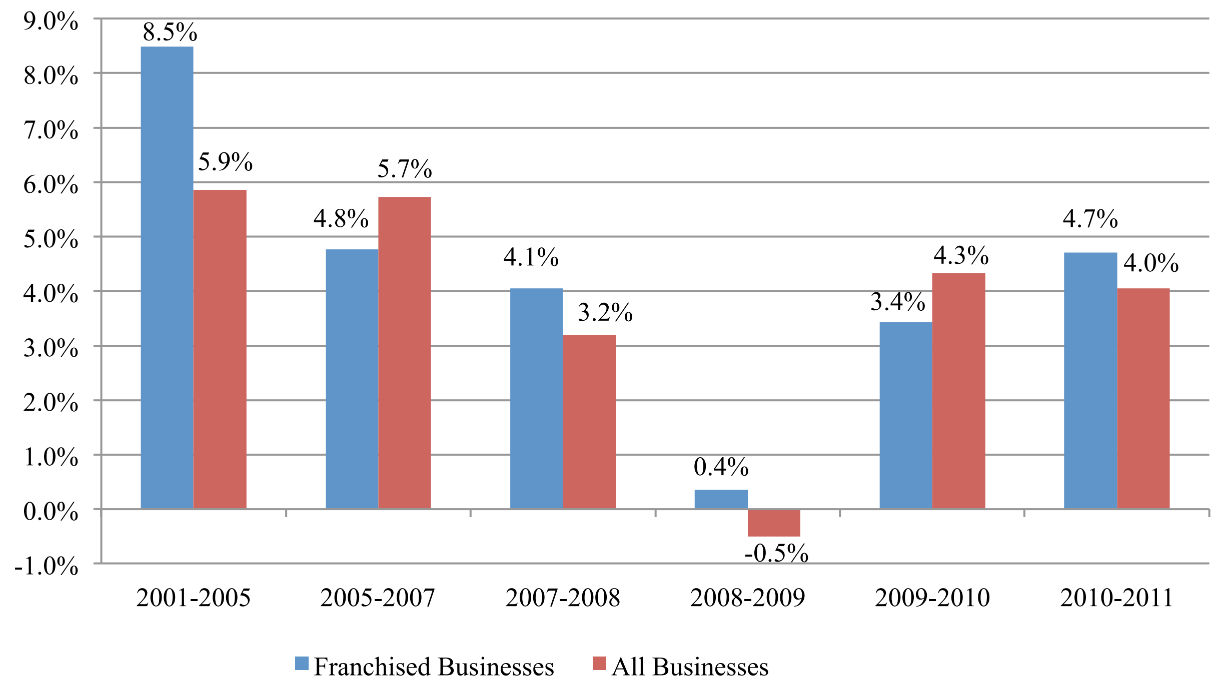
Much like the larger small business population, franchised businesses can be seen as engines of employment growth, especially in strong economic times. Data from the franchise economic impact studies conducted by PricewaterhouseCoopers suggests that total employment in business format franchised establishments grew at an average annual rate of 3.6 percent between 2001 and 2005 (Figure 1). Such strong growth coming out of the recession of 2001 contrasts with the growth for all businesses, which averaged 0.3 percent per year over the four year period. More recent growth, given the recession, has been slower but still indicates a faster growth rate for franchised small businesses. Figure 1 shows the average annual employment growth rates from 2007 to 2011. While all businesses declined rapidly during the depth of the recession in 2007 and 2008, franchised establishments recovered faster and have outpaced all businesses as a whole over the time period. Between 2010 and 2011, franchise employment is expected to grow 2.5 percent, compared to a 1.7 percent increase for all businesses. This is mirrored somewhat in the growth in output from franchise establishments, which is shown in Figure 2, over the same time period. Franchise

[13] See http://www.sba.gov/content/small-business-jobs-act-2010.

business output is expected to grow 4.7 percent between 2010 and 2011; whereas, the output from all businesses should increase 4.0 percent.

Given these statistics, if we are to close the "jobs deficit," franchising must be part of the discussion. Ideally, franchise establishments would return to the growth rates experienced earlier in the decade. That means, of course, that policymakers must address some of the challenges that franchisors and franchisees are facing, such as access to credit, which are dampening overall establishment and employment growth.. This is perhaps best shown in Figure 2, which shows the average annual growth rates in output for franchise and all businesses between 2001 and 2011. The more recent growth rates are well below what was experienced between 2001 and 2005, where franchise establishments averaged output growth of 8.5 percent and the output from all businesses rose 5.9 percent each year.

Figure 2: Growth in Output from Franchise Establishments and All Business Establishments, 2001-2011



Source: PwC (2008, 2011a, b); Inforum.
Note: The annual growth rates for all businesses include all private sector businesses in the United States and are not limited to those in franchise business format lines.

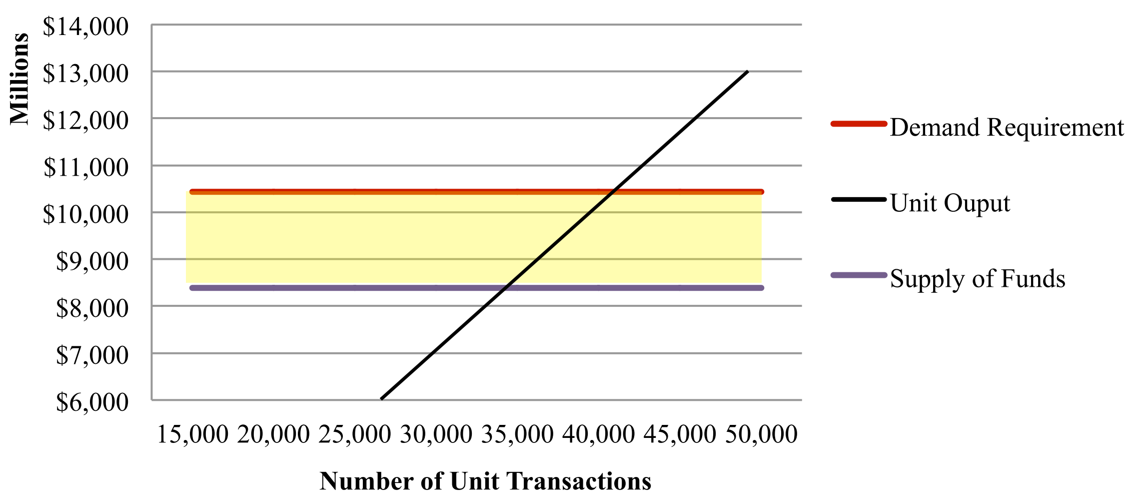
The International Franchise Association has referred to the lack of credit for its members as its "number one member issue" and one that is restraining franchised businesses' ability to grow.[14] In fact, 39 percent of franchisors report in a March 2011 survey that more than half of their existing or prospective franchisees have been unable to obtain necessary financing. Moreover, 60 percent of franchisors report no improvement in credit access in recent months, which is slightly better than the 65 percent reported in the November 2010 survey.[15] In that survey, 42 percent of franchisors and 30 percent of franchisees stated that credit access issues significantly impacted their ability to

[14]Reynolds (2011a), pp. 70-71.
[15]Reynolds (2011b).

grow their businesses in 2010.[16] To help to illustrate how credit is impacting their business, Appendix B shows some of the responses from franchisors and franchisees to the March 2011 survey.

Financing and credit, of course, are crucial elements to any business, and the recession and its continued aftermath have been painful for many. This experience is different from past recessions. Small business financing and credit have been constrained, both by tougher standards and by structural impediments due to the financial and housing market roots of the economic crisis. In fact, small business loans outstanding fell 6.2 percent between 2009 and 2010,[17] and the Federal Reserve Board's Senior Loan Officer Survey has reflected tighter commercial and industrial lending standards since 2007 and also weakened demand for lending overall. These figures were even more pronounced in the early months of 2009. While more recent surveys have shown improvement, the vast majority of senior officers reported no change in standards or demand.[18]

Figure 3: Effect of Projected Lending Shortfall, 2011



Source: FRANdata (2011).

As a result of more restrictive lending conditions, small franchised businesses are competing in a much tougher environment for capital. FRANdata (2011) estimates that there will be a demand for over 41,000 franchise transactions this year, which is up 12 percent from 2010.[19] Despite the uptick in demand, the report suggests that there will be a lending shortfall of more than $2 billion, which banks and the SBA may not be able to meet (Figure 3). This is not a trivial amount, as it represents nearly 8,000 franchise transactions. Under such assumptions, the lending shortfall would result in a loss of 82,334 jobs and $10.7 billion in economic output.[20] Therefore, the access to credit challenge is significantly impacting franchised small businesses' ability to grow this economy.

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[16] *Ibid.*
[17] Haynes and Williams (2011), p. 3.
[18] See http://www.federalreserve.gov/boarddocs/SnLoanSurvey/201102/default.htm.
[19] p. 11.
[20] pp. 18-21.

Small business lending challenges are being exacerbated by declining real estate values, limiting the ability of many owners to borrow. A recent NFIB survey found that nearly one-third of respondents felt that access to credit had become more difficult in the past twelve months. Among those who noted credit concerns, 29 percent of them cited poor sales and 25 percent mentioned business uncertainties as their biggest finance problem.[21] Moreover, there were 15 percent of owners who did not borrow because they did not think that their loan application would be approved – the so-called "discouraged borrower."[22] Depressed housing prices, low credit scores, and location (particularly in the most economically depressed areas) appear to influence one's ability to access credit, and when a small business approaches more than three lending institutions unsuccessfully, their chances of obtaining credit falls dramatically.[23]

Small business owners also cite public policy and regulatory uncertainty as a concern, with new rules being drafted on health care, financial regulation, occupational safety, and the environment, among others. Each year, the compliance cost for new regulations is estimated at $1.75 trillion, with smaller firms with less than 20 employees paying 36 percent more in compliance costs per employee than their larger counterparts.[24] Recognizing that the rulemaking process can be burdensome for all businesses – especially small ones – the President recently signed Executive Order 13563 which instructed agencies to adopt rules with the least burdensome approaches, taking into consideration the benefits of the regulations and the best available scientific evidence. This directive also instructed federal agencies to review existing regulations.[25]

Entrepreneurship and Net Job Creation

The economic downturn has highlighted the need for new economic engines of growth. Given the loss of over 7 million jobs, many policymakers have looked toward entrepreneurship as a mechanism for generating new employment, innovation, and competitiveness. Most Americans, in fact, see business creation and entrepreneurship as the best way of growing the economy and creating new jobs, and they suggest that government should do more to encourage individuals to start their own businesses.[26] This view is shared by politicians of both parties, all of whom espouse the belief that "Main Street" businesses benefit our overall economy. President Obama recently said the following on the importance of the entrepreneur:

> Entrepreneurs embody the promise of America: the belief that if you have a good idea and are willing to work hard and see it through, you can succeed in this country. And in fulfilling this promise, entrepreneurs also play a critical role in expanding our economy and creating jobs.[27]

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[21] Dennis (2011), p. 5.
[22] *Ibid.*, p. 1.
[23] *Ibid.*
[24] Crain and Crain (2010), p. 7.
[25] See http://www.whitehouse.gov/the-press-office/2011/01/18/improving-regulation-and-regulatory-review-executive-order.
[26] Schoen (2009).
[27] See http://www.whitehouse.gov/the-press-office/2011/01/31/white-house-launch-startup-america-initiative.

The White House has also introduced a new organization, the Startup America Partnership, to help promote entrepreneurship.[28]

Research on the role that small businesses play in net job creation is the main impetus behind these initiatives. The notion that small businesses generate most of the net new jobs has become commonplace[29] and part of the lexicon of speechwriters everywhere. Behind this statistic is a consistent theme: new ventures are essential in our dynamic economy to maintain our competitiveness, to generate new economic growth, and to produce new employment.

The Ewing Marion Kauffman Foundation has said that start-ups, most notably those firms that are less than five years old, are the key to net job creation, and public policy should therefore focus on the entrepreneur.[30] They find that start-ups have been the primary drivers of net employment changes since 1977. Indeed, some economists argue that the size of the business is really not the contributing factor; instead, studies should focus more analysis on the age of the firm. Young startups account for 3 percent of the total employment in the country but represent 20 percent of the gross job creation.[31] While new firms shed employment rapidly, with 40 percent of the jobs initially created at startup lost after five years, these young firms tend to grow more rapidly than old firms and generate more net new employment overall.[32] Much of this is a function of the fact that young firms represent such a large proportion of all businesses at any given time, building in a structural advantage for newer firms to generate more net new jobs.[33]

Other studies show that age of the firm is more indicative of growth than the size of the firm, with more mature businesses being the driving force. High-impact firms, according to one recent study, are those that have doubled their sales and had their employment growth quantifier at least double over the most recent four-year period.[34] This research has found that the average age of a high-impact firm was 25 years old between 2002 and 2006, and perhaps surprisingly, these firms were in every major industry and were located across the country in every state, region, and county.[35] Identifying and cultivating these firms, which change over time, and allowing them to flourish is the key.

In order for a business to succeed and generate new employment, though, it must be able to navigate a difficult competitive landscape and to scale up to effectively meet growing demand. This is often difficult. Firms which last four years have often passed a significant threshold in their survivability.[36] For those businesses that are successful, transitioning to a "second stage" of their lifecycle brings tough financial, management, and logistical challenges which many novice entrepreneurs are not ready to tackle. Policies geared toward start-ups are not as helpful, and therefore, new initiatives might need to be undertaken to nurture this small but economically vibrant group of businesses. Florida provides an excellent example and test case for this approach, as its legislature in 2009 created an Economic Gardening Institute at the University of Central

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28 See http://www.startupamericapartnership.org/home.
29 Headd (2010).
30 Stangler and Litan (2009) and Kane (2010).
31 Haltiwanger, Jarmin, and Miranda (2010), p. 31.
32 *Ibid.*, p. 30.
33 Stangler and Kedrosky (2010).
34 Acs, Parsons, and Tracy (2008), p. 17.
35 *Ibid.*, pp. 1-2.
36 Knaup and Piazza (2007), p. 3.

Florida that provides counseling and other services to fast-growing businesses.[37] Similarly, the Kauffman Laboratories for Enterprise Creation recruits and provides technical support to top entrepreneurs to help make their ventures successful.[38]

The Franchise Business Model Provides Scaling Advantages and Generates Jobs

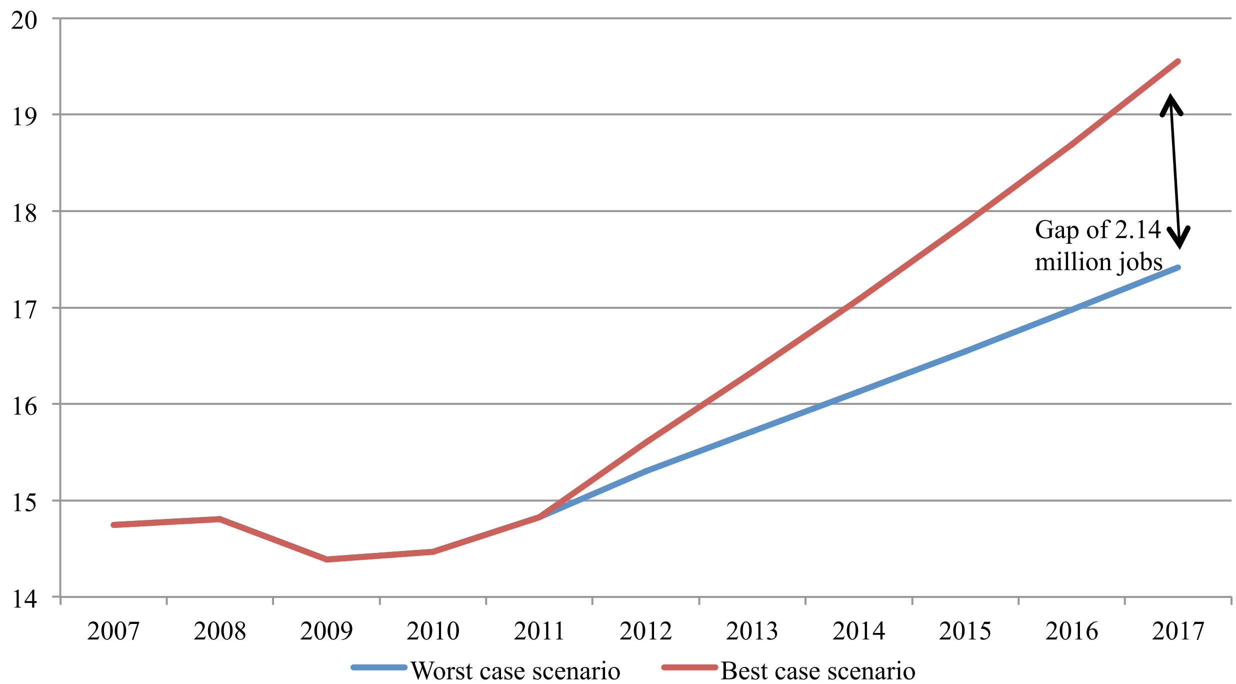
Franchising provides another method of scaling up quickly, providing new entrepreneurs with proven techniques and tools to move to the "second stage" with the right tools. Research, for instance, has shown that franchising can enhance a firm's survival and growth, especially for those franchises that grow most rapidly in their early years.[39] Indeed, a franchisors' growth is highly dependent on its prior performance,[40] and as such, it is important to establish oneself at the start-up phase with strong resources and an orientation for success. When doing so, the franchise business model can provide an important mechanism for quick scalability and, under the right circumstances, to outperform their non-franchise counterparts. A few past studies have found this to be the case. Spinelli, Birley, and Leleux (2003) observed that U.S. public franchises bested the Standard & Poors 500 returns in nine of the ten years that they studied, and Aliouche and Schlentrich (2005) provided evidence that franchised restaurants had greater market value than those which were not franchised.

Earlier in the paper, it was suggested that franchised establishments need to be part of the discussion when it comes to overall employment and output growth in the U.S. While these data are not perfect comparisons, it does provide some clues – especially in terms of relative growth rates – about the importance of franchising as a sector in generating net new jobs. Indeed, it suggests that there might have been some "high-impact" franchises during this period. In most of the sectors, franchise establishments had higher or comparable employment growth with their non-franchised peers.[41]

One of the primary findings from Figure 1 is that even during the recent economic downturn and period of tight credit, employment growth in small franchised establishments has outstripped the growth of all other businesses. This helps to support the claim that franchising is relatively resilient, both in good and bad economic times, at generating jobs and output (Figure 2). In the good times, when credit is flowing and the economy is booming, franchising can be a tremendous locomotive for job creation. Yet, we also know that franchisors and franchisees have said that the lack of credit has hurt their ability to grow their businesses. Figures 1 and 2 also show us this, as tight credit conditions stalled both job and output growth between 2007 and 2009.

[37] See http://www.growfl.com/.
[38] See http://www.kauffmanlabs.org/.
[39] Michael (2002).
[40] Castrogiovanni and Justis (2002).
[41] One possible extension to this analysis would be to identify high-impact franchised businesses and examine their contributions to overall economic activity relative to their non-franchised peers. Given the evidence that franchising often outperforms other businesses in terms of growth, this could be quite informative.

Figure 4: Projected Franchise Employment Growth under Different Credit Scenarios, 2007-2017
(Cumulative Effects on Direct and Indirect Employment from Business Format Franchises, in million



Source: Authors' calculations using data from PwC (2008, 2011a, b).

Looking ahead, franchising should be part of any discussion on employment and overall economic growth, especially in light of the before-mentioned "jobs deficit." Figure 4 illustrates this point by showing the potential growth in franchising under different scenarios through 2017, or ten years beyond the Economic Census data. Under the best case scenario, we will assume that credit is readily available, with franchisors and franchisees lending needs being fully met. The other scenario, which is more pessimistic, is one where credit conditions are tight. With each successive year, we can see the cumulative impacts of growth under each scenario.

Both historical and current data are used to derive the two scenario forecasts in Figure 4. Suffice it to say that these are rough estimates, both because these are such uncertain economic times and because only limited data exist on annual employment in franchising. For both scenarios, estimates for employment growth from the Economist Intelligence Unit (EIU) were used for 2011 to 2017. [42] For the best case scenario, where credit is available and the business conditions are favorable, we have consistent data for franchise job growth from 2001 to 2005. During this period, job growth in franchising outstripped the growth in total U.S. jobs by 3.3 percent each year. If we were to apply a similar "premium" to the EIU forecasts for 2011 to 2017, direct and indirect employment in business format franchising would grow by over 5 million.

[42] EIU has the following estimates for employment growth: 1.9 percent (2012), 1.4 percent (2013), and 1.3 percent (2014 to 2017).

In contrast, the more recent experience of tight credit (2007 to 2011) illustrates a period when credit conditions were less favorable. The resiliency of franchising, however, enabled franchised small businesses to grow faster, or shrink less, than other U.S. businesses. During this time span, franchising grew 1.3 percent better than other firms on average each year. To continue our example, under the worst case scenario if we were to add a 1.3 percent "premium" to the EIU estimates for employment growth between 2011 and 2017, overall direct and indirect franchise employment in business format franchising would grow by almost 3 million.

In sum, the franchising industry has had and will continue to be a significant contributor to job creation. With a positive business environment, which includes access to credit but might also encompass a favorable tax and regulatory climate and a growing economy, small franchise establishments can help to close the "job gap" that currently exists due to the severity of the 2007-2009 economic recession. Franchises alone, assuming the best scenario presented above, could help close the gap by adding over 2 million jobs more than if the economic environment over the next six years is closer to the tight credit scenario. This simulated exercise demonstrates the true potential of franchising as an economic engine under ideal circumstances, and it highlights the need for greater credit access to franchisors and franchisees moving forward.

Franchising Opportunities and Global Competition

Another avenue for job creation and economic growth is through increased trade. The President has said that he wants to double U.S. exports by 2015, creating the National Export Initiative (NEI) by Executive Order 13534.[43] To achieve the goal of exporting $3.1 trillion of goods and services by 2015, the Administration plans to focus on five areas:

- Improving overall trade promotion of U.S. goods and services abroad
- Increasing access to export financing, especially for small businesses
- Removing barriers to trade
- Enforcing existing trade rules
- Promoting "strong, sustainable, and balanced growth" globally

Some of these components are more challenging than others, but highlighting the importance of this initiative, it was singled out in the FY 2012 budget for continued financial support[44] and a large number of Cabinet-level officials and their staffs have been devoted to this cause for much of the past year.

International markets provide domestic franchisors with tremendous opportunities for growth. While GDP is expected to grow around 2.5 percent in the advanced economies – including the United States – this year, economic growth in emerging markets is forecast to expand around 6.5 percent.[45] In promoting the NEI, the U.S. Department of Commerce writes the following:

> 95 percent of the world's customers lie outside the United States; we ignore them at our peril. Tapping into customers in fast-growing markets abroad and in our traditional markets is crucial to putting the United States' own economy on a solid footing – and generating the

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[43] See http://www.whitehouse.gov/the-press-office/executive-order-national-export-initiative.
[44] See http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/commerce.pdf.
[45] IMF (2011), p. 2.

> demand needed to put Americans back to work. We cannot return to an economy that is driven by borrowing and consumption. To maintain robust growth, the world will need to rely less on U.S. consumption – and we will need to sell more to the rest of the world.[46]

Indeed, franchised small businesses have been doing just that, providing new franchisee opportunities abroad and drivers of new employment and growth for franchisors.

Recently, the Subway sandwich chain overtook McDonald's as the world's largest restaurant chain in terms of number of units, with a lot of press attention.[47] (McDonald's still dominates all restaurants when it comes to sales revenue.) In reading through these stories, though, it is clear that Subway's success stems from its growth overseas. While just over 70 percent of its stores operate in the United States, its current growth and long-term expansion plans lay elsewhere, particularly in Asia, where it will open its 1,000th location, and other emerging markets. It is not alone, according to the *Wall Street* Journal. "Starbucks Corp. recently said it plans to triple its number of outlets in China, for example. Dunkin' Brands Inc., parent of Dunkin' Donuts and Baskin-Robbins, plans to open thousands of new outlets in China in coming years as well as its first stores in Vietnam in the next 18 months."[48]

Clearly, the franchise model provides scalability and growth globally, which helps to create high-paying jobs in the U.S., particularly at the franchisor's headquarters. Indeed, international expansion often requires highly-skilled professionals who are capable of navigating complex country-by-country legal and regulatory frameworks and who can help to custom tailor a company's product or service to cater to local tastes.

Further, the expansion of U.S. franchise businesses abroad can directly help the U.S. international balance of payments. This is a powerful benefit because the U.S. has run trade deficits for the past three decades. Payments from franchisees abroad flow into the U.S. as they pay their royalties to U.S. franchisors. Of course, such royalty payments increase with a growing global economy, and for U.S. franchisors to be able to pursue international opportunities, they must have the resources domestically – readily-available credit access and favorable business conditions – to make such global expansions a reality.

Concluding Remarks

Franchised small businesses are an integral part of the economy, generating employment and output at rates faster than all other businesses. Indeed, the franchise business model provides key resources to entrepreneurs wishing to open their own establishments, and it allows for these business owners to scale up quickly. Such advantages help franchisees and franchisors weather even difficult times. This year, business format franchise output is expected to grow 4.7 percent, with employment up 2.5 percent, outpacing all other businesses by 0.7 percent and 0.8 percent, respectively. Even during the recession of 2007-2009, franchised businesses weathered the downtown better than many other businesses. For that reason, it will be important for policymakers to make franchising part of the discussion when pursuing solutions to grow this economy.

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[46] U.S. Department of Commerce (2010), p. 1.
[47] See http://online.wsj.com/article/SB10001424052748703386704576186432177464052.html.
[48] *Ibid.*

Under the right business conditions, franchises should flourish. If we have the right mix of tax and regulatory policies, a growing economy, and sufficient credit for both franchisees and franchisors, franchise employment could grow substantially over the course of the next few years. However, if these conditions are not met, franchises will not be able to grow as rapidly, nor will any small business. More recent experiences, for instance, bear this out. Growth in employment and output since 2007, when credit conditions have become tighter, is far below what it was between 2001 and 2005. If we could return to those earlier growth rates, we could help to close the "jobs gap" by employing more Americans.

Of course, challenges continue to prevent that from happening. Access to credit, while improved from its recessionary lows, is still a problem for many business owners. In a recent survey, 39 percent of franchisors suggested that at least half of their existing or prospective franchisees had been unable to obtain necessary financing. Moreover, FRANdata estimates that there will be a $2 billion shortfall in lending to franchises in 2011, with the demand for loans exceeding the willingness of banks and other financial institutions to supply them.

It is for this reason that the International Franchise Association has deemed "access to credit" as its number one issue. FRANdata (2009) found that $1 million in lending to franchised businesses creates or sustains an estimated 40 jobs and generates an estimated $4.2 million in economic output. Increasing capital flow to the franchising sector can have a very positive impact on the pace of the U.S. economic recovery. Likewise, constrained capital flow will have a negative impact and will slow the rate of the economic recovery. While government has introduced innovative, and often temporary, solutions to help rectify this problem, the franchise community should work on long-term structural solutions in collaboration with its lending and other partners to ensure adequate business capital moving forward.

In closing, this paper has helped to establish the important role that franchises play in the American economy. Despite the economic challenges of the past few years, business owners are more optimistic this year than last, and franchising remains a viable option for many entrepreneurs wishing to pursue the "American Dream." These franchised small businesses will offer innovative new products and services to consumers. Many of these entrepreneurs will also open up new opportunities for growth by pursuing new markets overseas. Undoubtedly, the future of franchising looks bright, especially if the business environment provides a fertile ground for these firms to prosper and grow.

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Appendix A: What is a Franchise Business?

When an individual decides to go into business for themselves, franchising can be an attractive option. Entrepreneurship requires major investments in time, resources, and finances, and not all ventures are successful. In fact, only 44 percent of new establishments survive four years, with 31 percent surviving to year seven.[49] Therefore, franchising provides a way of being your own business with proven products and methods, start-up and operating assistance, increased purchasing power, and regional and national marketing support.[50] This should enhance one's ability to success, as shown elsewhere in this paper. This section highlights the importance of franchising to the U.S. economy and describes the different types of franchised businesses.

Franchising in the U.S. Economy

According to U.S. Census Bureau data, as adjusted by PwC to include nonemployer establishments based on data from other government agencies including the U.S. Bureau of Economic Analysis, franchised businesses represented 2.8 percent of all non-farm business establishments in 2007, operating 828,138 establishments. These businesses were directly responsible for over 9.1 million jobs and $468.5 billion of GDP.[51] This, of course, is only part of the story, as there are also multiplier effects to franchised establishments. It is estimated that, when accounting for these direct and indirect impacts, franchising accounts for 9.7 percent of nonfarm GDP and contributes 17.4 million nonfarm payroll jobs.[52]

These businesses spanned a wide variety of industries; although, restaurants accounted for nearly half of all employment in business format franchises (Figure A-1). Business format franchises are the most common type of franchise, with franchisees following standardized operating guidelines as established by the franchisor while also benefiting from its established sales and marketing resources.[53] In this category, quick service restaurants comprised 37.1 percent of total employment, the largest of any group, followed by full-service restaurants with 12.7 percent and business services with 12.4 percent. Conversely, when examining these industries by their total impact on GDP (Figure A-2), the top three are quick service restaurants (21.0 percent), business services (19.4 percent), and real estate (13.0 percent). In addition, 86 percent of establishments that use the business format franchise model are owned by a franchisee, with the remainder being company (or franchisor) owned.[54]

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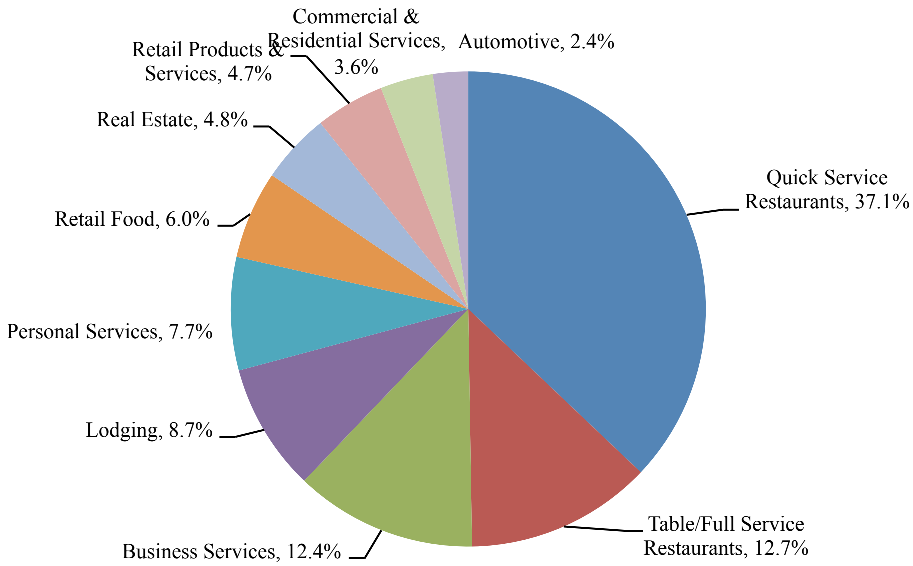
[49] Knaup and Piazza (2007), p. 4.
[50] For a listing of advantages and disadvantages for owning a franchise, see Beshel (2010), p. 10.
[51] PwC, p. I-6.
[52] p. I-7.
[53] Beshel (2010), p. 6.
[54] p. I-9.

Figure A-1: Distribution of Jobs in Business Format Franchises, 2007

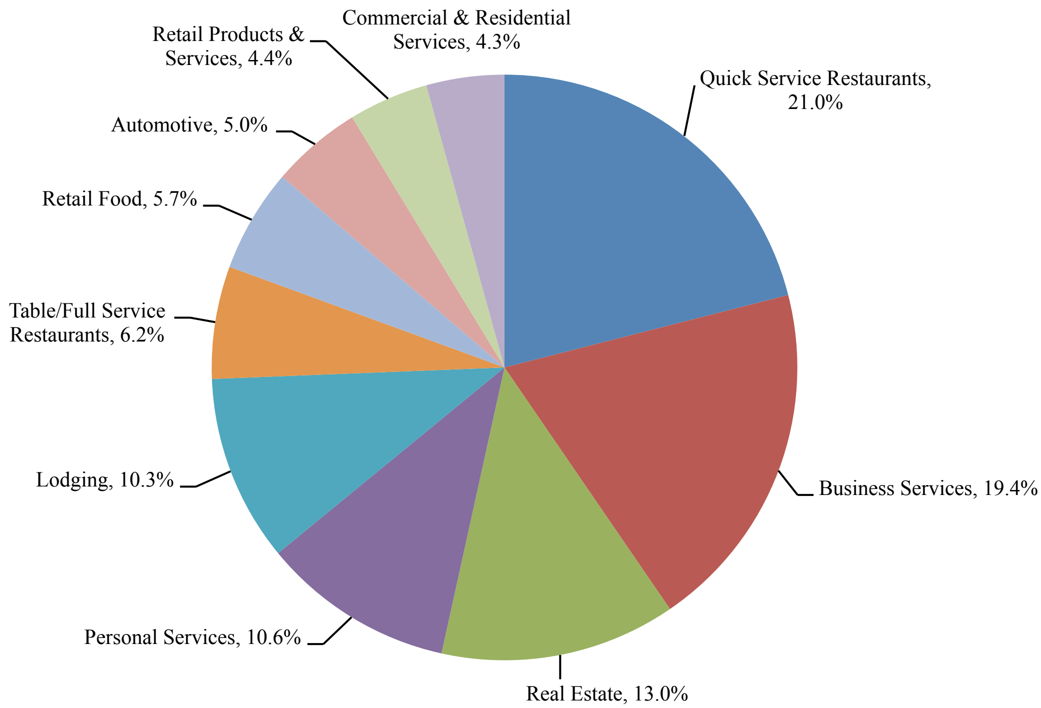


Source: PwC (2011), p. I-8.

Product distribution franchises account for just under 40,000 franchised establishments in 2007, differentiating them from business format franchises. This type of franchise is one in which the franchisee is part of the overall distribution chain of the franchisor, with the best examples being in the soft drink, automobiles, or gasoline sectors.[55] Franchising, for instance, accounted for 71.9 percent of total employment among automotive and truck dealers, 40.8 percent of gasoline service stations that did not have a convenience store, and 14.5 percent of beverage bottling industry.[56] These businesses provided 1.4 million jobs and accounted for $89.6 billion of GDP.[57]

[55] Beshel (2010), p. 6.
[56] PwC (2011), p. I-10.
[57] p. I-7.

Figure A-2: Distribution of GDP in Business Format Franchises, 2007



Source: PwC (2011), p. I-9.

Appendix B: Credit Access Survey Responses

The International Franchise Association conducted a survey of franchisors and franchisees from March 7 to 11, 2011, to gauge access to credit challenges for these business owners. It was designed to see how credit conditions had improved for this group since a similar survey was conducted in mid-November 2010. The full results of the survey can be found online.[58] This section will highlight some of the direct responses from those small franchise establishments which responded that the lack of credit had impacted their business. A fair number of respondents skipped this question, but for those which did answer it, it is instructive.

Franchisors

Respondents were asked to give examples of either a current franchisee or franchisee prospect who has encountered difficulty with getting access to credit. Here is a sample of some of the responses:

- "Several prospects were unable to obtain credit and we were not able to complete purchase of a franchise."
- "We have had to work hard to help franchisees find lenders to work with; however, we have been able to successfully place 100% of our approved franchisees in loans. We have re-evaluated our criteria we are looking for in regards to liquidity from 2007 to now, but with hand holding, our franchisees do secure financing."
- "We had a prospect that signed a Franchise Agreement in 2009 to establish our first location in Las Vegas. Despite being well qualified with both cash and assets, the prospect could not get financing…. The prospect eventually abandoned that effort in June, 2010."
- "New prospective franchises are finding it VERY difficult to obtain financing which makes it difficult to consummate deals."
- "We have found that for the individual franchise owner prospect, lending has diminished. Some of this is due to the fact that 2 years of poor economy, the failure of the housing market, have left these individuals using their 401k, or have lost [much of the] equity in their homes. This has been the prime source for establishing a loan."
- "Had an individual in New York. He was determined to buy our franchise. This was his `soul mate' in reference to the ideal business. We put him in touch with several lenders and he could not get financed, although he had a good credit score."
- "I have a candidate I have been working with for over 14 months…. He has worked with over 20 banks, all with no success in getting the deal financed. He has a strong personal financial statement, but still can't get a loan. The banks are looking for a no risk loan and still making it difficult. They are asking for direct industry experience, 25-30% cash injection, high levels of collateral and high cash reserves. If someone has all those things, they are not typically looking at starting new concepts… they are most likely investing in the concepts that have experienced success in the past. Very frustrating."
- "Since we are carefully vetting our franchise prospects' financial position and are only working with those individuals who are qualified for financing, we are not encountering difficulties."
- "Franchise prospects with good credit are being asked for ridiculous collateral ratios combined with liquid capital. If they had these kinds of funds available, they would not need the bank for a loan to start a business."
- "A new franchisee who was a former … franchisee and had dealt with a local banker with SBA for many years. He was unable to get a loan to start his new [franchise]. Through another financial

[58] Reynolds (2011b).

source who had set up an innovative way to get qualified candidates/ franchisees a line of credit, obtained this line of credit within 48 hours."

- "Most candidates we assist in matching with quality franchise companies in the past were able to finance their business with home equity or the 401k program. With the unemployment so high, we should be helping candidates find [opportunities] as an entrepreneur. Now that American Dream is fading. Remember all franchise opportunities aren't millions. Help assist the "everyday" entrepreneur with smaller loan amounts under $250k."
- "The vast majority of people inquiring about our business aren't able to obtain funding."
- "We have been informed by SBA that if we were a successful company, they were not interested in guaranteeing our loan. Their purpose is more of a rescue vehicle for struggling companies or companies failing for lack of funding. Our financials were too strong to be of interest and would not allow them to fulfill their mission."

Franchisees

Similar to the survey for franchisors, franchisees were asked to describe issues that they were experiencing with limited access to credit. The following are examples from those who responded to the question:

- "I have an SBA loan that I wanted to restructure. My SBA lender said that there were no programs available to existing borrowers."
- "I tried to sell my businesses in 2010 and am still trying in 2011, but buyers cannot obtain credit to purchase a resale franchise."
- "The total credit line on one of my accounts was reduced by 35%."
- "Not able to sell troubled assets."
- "Limited access to credit has kept me from adding additional positions, vehicles, and equipment for growth."
- "I tried two local banks for a loan to pay off existing debt and was simply told that we are not making loans to small businesses at this time. It was clear there was no interest on their part to even have the discussion."
- "Affects my clients more than me. Some clients have not been able to obtain credit to purchase products or services from me."
- "Business credit card limit lowered 45%, despite having a strong history of on-time payments on all my debts."
- "My business relies on my clients' ability to get credit to fund the purchase of their business. Most have used 401k funds rather than … secure bank funding."
- "My clients' limited access to credit has deeply impacted my business. If there were able to finance my services then [my] business would be able to rebound."
- "Sustained lack of business due to low consumer confidence would likely preclude me from getting a loan."
- "We suffered significant losses in revenue in 2008 and especially 2009. This caused the business to suffer the first financial loss years since the mid-1990s."
- "Limited my ability to carry receivables and to handle my expenses during the normal seasonal downturn."
- "The banks won't hardly talk to you. If they did, they required mountains of paperwork before turning you down."
- "I need business, not credit."