

Tired and Tested

By Joel Groover

Looking around at the suburbs of northeast Phoenix a few months ago, Dean Kinnoin spotted just that sort of gap between supply and demand that makes a would-be entrepreneur grab the nearest cocktail napkin and start scribbling. “Arizona is baseball-rich,” he said, “but out in this area, the Far West Valley, there are not a lot of places where the community can go for equipment.” Kinnoin, a lifelong fan of the game had always dreamed of running a baseball-related business. And now his new store, a 2,600 square foot training and equipment center aimed at the area’s abundant baseball and softball teams, is slated to open at a grocery-anchored shopping center by the end of the summer.

Back when financing was cheap and easy, the sign above the shop might have read “Dean’s Baseball Shack” or some such. But in today’s tight economy, entrepreneurs are reluctant to go it alone with such mom-and-pop concepts, experts say. Instead, they are more likely to sign with established franchises that require up-front fees of up to \$50,000 along with a steady stream of royalties. Kinnoin went with Extra Innings, a Middleton, Mass. - Based franchiser with 40 franchisees across 19 states. “The support you get is a huge plus,” Kinnoin said. “It helps with your loan, too. [Lenders] know you’ve already got a successful business plan in place.”

When negotiating with landlords, both franchisees and franchisers tend to trumpet the benefits of the franchise model: Franchises, they say, enjoy better access to financing, stronger brand recognition and proven business models that make them safer bets. The strength of this argument, particularly in today’s risk-averse economy, is part of the reason franchises are now supplanting mom-and-pops at many shopping centers, experts say. But this does not mean negotiating a deal with a franchise is always a straightforward, cookie-cutter affair. Boosters of the franchise model often say prospective franchisees are carefully vetted to protect the brand, but skeptical scoff at these claims.

“The old line in the franchise industry is, ‘If you can fog a mirror, you can buy a franchise,’” said Mario L. Herman, a Washington attorney who often represents franchisees in disputes with franchisers. And though some franchisees are multiunit operators with real estate savvy and annual revenues worthy of a publicly traded retail chain, others are unprepared newcomers with paltry cash reserves and a poor grasp of what it takes to run a lone sandwich shop or fitness center.

“You cannot broad-brush what a franchise is,” said Jonathan Gould, CEO of Stonemar Properties, a New York City-based real estate management and investment firm. “It’s all about who you are dealing with. You have to do your due diligence and have a good feel for what will work at a location.”

The newfound confidence among franchisers was noticeable last spring at ICSC’s RECon meeting, where national and regional brands were talking about growth once again after several years of stalled expansion plans, said John F. Bemis, Jones Lang LaSalle’s executive vice president and director of leasing. “We certainly saw a lot of activity out of the franchisers,” Bemis said. “There was a definite uptick, because the market for franchisers is better. Today you’re seeing a lot of people from corporate America who have been downsized or are looking to make a life change. They can rely on the Franchise for help with recipes, advertising, cash management - areas where they lack experience.

Even established mom-and-pops are now more likely to embrace the franchise model, says Deborah Sweeney, CEO of MyCorporation.com, which helps new franchises incorporate and form limited-liability companies online. “We have seen quite a bit of conversion franchising, where an independent business converts to a franchise,” she said. “This might be because they’re seeing financial trouble and need to get that instant brand-recognition and buying power, or because they need additional financing.”

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Some of today's fastest-growing franchises, according to Sweeney, are Clean Air Lawn Care, Ecomaid, Huntington Learning Center, Pets Supplies Plus and Pizza Fusion. Strong demand for child-care centers, low-cost gyms and quick-serve spas is fueling growth in these franchise categories as well, she says. "Massage Envy is a huge spa franchise that we have been seeing a lot of," Sweeney said. "It is not the whole spa experience per se, but is a less expensive option."

LaVida Massage is another example. This Commerce, Mich.-based franchiser has doubled to 30 locations since 2007, in the U.S., Canada and the Middle East. Landlords are keen on LaVida's no-inventory business model, says founder John Hoose. "Most businesses are inventory-based, which means landlords have to worry about that tenant having the ability to get lines of credit to secure product for their store," Hoose said. "Many mom-and-pops don't have the wherewithal to get that kind of bank financing. They go in undercapitalized and put the landlord at risk." As an added benefit, service-based franchises are safely beyond the crosshairs of Internet retail, Hoose says. "When we started, we knew we had to get into a business that was service-based, where there was no inventory to be manipulated by the Internet or sent to a Third World country to be manufactured," Hoose said. "The Internet pushed us here."

Naturally, franchisers are bullish on their businesses. But as landlords evaluate potential franchise tenants, they should protect themselves by being skeptical, said Kenneth S. Katz, cofounder and principal of Houston-based retail brokerage Baker Katz. An unstable, underperforming unit might easily be counted as a success by the franchiser, despite any headaches suffered by the landlord. "In the franchise world, the 'success rate' often means the store has not closed," Katz said. "So when a franchisee spends \$200,000 building out a store and then has to sell it at a loss for \$100,000, that is still a successful store to a franchiser, by the way they compile their stats."

A few years ago franchisee lawyer Herman successfully sued a postal franchiser for its practice of wooing franchisees with misleading numbers. "They claimed a 98 percent success rate," Herman said. "But they defined

success as an open unit, ignoring the multiple failed franchisees that came through that unit." Herman advises landlords to question even the assertion that franchises outperform independent stores. "There have been plenty of studies out there suggesting that independents have a better chance of succeeding than franchises," he said. "If the landlord is thinking: 'Well, if it's a franchise, it has to be a pretty good deal, with a high success rate' - that ain't necessarily so."

When franchisees end up in financial trouble, Herman says, they typically get embroiled in nasty disputes with franchisers over the likes of sublease arrangements, royalties or whether the franchiser's business model actually works. This infighting makes the landlord's life more difficult. It also increases the odds that the tenant will simply take down the franchiser's shingle and try to operate as an independent, a move that often works, because franchisers are loath to shell out the legal fees needed to force franchisees back into the system. "The landlord is just scratching his head and saying, 'Hmm, I wanted a national brand in here, and now I've got this mom-and-pop,'" said Herman.

Lease negotiations with franchises also can be more complicated, says Ron Deluca, vice president of tenant representation at R.J. Brunelli & Co., an Old Bridge, N.J.-based retail brokerage. "Landlords, when dealing with a franchisee, always have the challenge of figuring out how credible the person is who wants to lease from them," he said. In response to this uncertainty, a common tactic is to try to extract a bigger security deposit from the franchisee, but this, too, carries risk. "What are you doing to the franchisee? You're pulling operating cash right out of his bank account," Deluca said. "His cushion is not there."

Landlords must get lease terms approved by both the franchiser and the franchisee, which can slow the negotiation. Another key question is whether the franchiser will guarantee rent payments if the franchisee goes under. "The whole dynamic of whether you have the franchiser on the hook or not, that makes a huge difference obviously to the landlord," Gould said. "In some cases, the franchiser comes in with the intention of taking a location and then selling it as a package to an

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individual. If the intent is to sell the location, is the franchiser still tied to the lease after the sale? That is a threshold question for the landlord.”

No wonder some landlords prefer dealing with franchisees whose businesses are so large they resemble big-name retail chains. “At one point Schostak Brothers up in Detroit had well over 100 Burger Kings,” Bemis said. “You’re talking about a nine-figure business.” Technically, Allendale, N.J.-based Doherty Enterprises also is a franchisee—albeit one that owns a total of 94 Applebee’s, Panera Bread Company and other restaurants. “They’ve got 16,000 employees,” Deluca said. “Landlords know a group like Doherty is solid and experienced. That’s a whole different ballgame.” For Gould, a key consideration is whether the franchiser is one of these veteran operators or a relative newcomer that aggressively sells its units to franchisees with varying degrees of creditworthiness.

Such complications notwithstanding, franchises still have a significant edge over mom-and-pops, thanks in large part to today’s tight financing market, says Bemis. “This is going to continue for the next several years,” he predicted. “Entering into the retail world as a mom-and-pop is a very difficult endeavor, because you have to figure out everything for yourself. The advantage of entering as a franchisee is that somebody has already made a lot of those mistakes for you.”
