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The Significance of Frnshise

Branislav Djordjevic

Abstract

Any company that aspires in industry must think in terms of global, not domestic market leadership.This chapter focuses on frnachise or expanding beyond domestic bou- ndaries and competing in the market of either a few or a great many countries. In the pr- ocess of exploring these issues, we will introduce a numbere of core concepts. The chap- ter includes section of market expansion, types of franchising, the benefits of buying a frnachise, acquisition, one method of valuaton end etc.

Key words: market expansion, franchise, shaping franchising, acquisition, end so far.

INTRODUCTION

The expansion of a venture is its period of unfolding and maturation. In everyday speech, there is little difference in meaning between "growth" and “expansion." In busin- ess parlance, the terms sometimes differ, with "growth" having the connotation of an int-ernal or vertical surge, whereas "expansion" refers to external or horizontal growth, su- ch as that exhibited by a firm that successfully engages in mergers and acquisitions. In reality, however, very few ventures reach the latter stage of opera¬tion; most entrepreneu- rs are quite content to aim for some degree of vertical growth, to settle for a comfortable position in the marketplace. Thus this book uses "expan¬sion" broadly for an advanced st- age of venture development that includes activities such as market expansion through fra- nchising, a rapid sales growth drive, exporting, and acquisition.

Market Expansion

A graph of the typical venture growth cycle (Exhibit 1.1) shows that continuing growth with no interruption is unlikely. At each stage of venture development, most firms face a decline period. Frequently, what brings the enterprise back up is some change that forces growth. In other words, pursuing expansion and growth is often a strategic nece- ssity rather than a choice. Expansion can be necessary even when a firm's sales are continuing to increase. If a firm invests its resources in vertical growth, its growth is limited by the size of the market and its own capacity. Unless the market is increasing explosively, a decline in the rate of growth is inevitable. Exhibit 1.1. Illustrates the point. (Source: International trade Administration and the U.S. department of Comerce)

EXHIBIT 1.1. A Declining Growth Rate with Sales Increases Each Year

Stage of Growth	Sales	Sales Increase	Rate of Growth
Startup	0	0	—
Development			
Early	$ 100,000	$100,000	
Later	500,000	400,000	400%
Rapid	700,000	200,000	40
Growth			
Early	900,000	200,000	29
Rapid	1,000,000	100,000	11

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The market and its own capacity. Unless the market is increasing explosively, a decline in the rate of growth is inevitable. Exhibit 1.1. Illustrates the point.

Whether the firm faces a decline in actual growth or a decline in the rate of growth, the entrepreneur normally has three broad options:

1. Market expansion driven by a motive of defence. If the firm's objective is not the pursuit of continuing growth but merely a comfortable position in the market¬place, the entrepreneur needs to consolidate all its resources and form a long-term defensive strategy to continue improving its cost performance. The firm may, for example, engage in research and development (R&D) and attempt to adopt new technologiies appropriate to strengthening its competitive position. These undertakings may push the firm into exp- ansion of its distribution, penetra¬tion of new markets, diversification, and gradual increa- se in production.
2. Market expansion driven by a goal of growth and expansion. In this situation, the entrepreneur must seek rapid market expansion. Simple vertical growth, like that att- ained by diversification, is not sufficient to better the rate of growth or even to maintain a high one for a long period of time. One quick method of mar¬ket expansion is franchising, an aggressive method of marketing, that, if success¬ful, can raise the growth rate within a very short period of time.
3. Market expansion driven by a goal of achieving market power and profit. If the entrepreneur uses careful, high-leverage financial planning to engage in mergers and acq- uisitions, it is possible to acquire great market power and a high rate of profit on investm- ENT.

Of these three expansion models, market expansion driven by defensive motives requires no elaboration. The franchising and acquisition strategies are discussed in this chapter.

Other goals may drive the firm to expand its marketing through exporting or it's financing by selling shares publicly. These strategies are also discussed in this chapter.

Franchising

Franchising is booming. Since 1990. Sales by franshised businessess have grown ten times faster than the U.S. economy as a whole. . Much of its popularity arises from its ability to ofter those who lack business experience the chance to own and operate a business with a high probability of success. Today, more than 4.500 franchisers operate some 570.000 franchise outlets throughout the world, and more are opening at an incredi- ble pace. A new franchise opens somewhere in the world every day six-and-a-half minu-tes. . Franchises account for 42 percent of all retail sales, totaling more than 4810 billion. Franchises also employ more than 8 million people in more than 70 major industries.

Franchising's semi-impressive growth will continue into the next century. Exper- ts predict that, by 2004. Franchises will be ringing up sales of $2.5 trillion world wide. By then, franchising will account for 50 percent of all retail sales. An International Fra- nchise Association spokes person says that franchising "will become the dominant from of retailing in most of the developed countries around the world."

In franchising semi-independent business owners (franchisees) pay fees and roy- alities to a parent company (franchiser) in return for the right to sell its products or servic- es and often to use its business format and system. Franchisees do not establish their own autonomous businesses; instead they buy a "success package" from the franchiser, who shows them how to use it. Franchisees, unlike independen business owners, don't have the freedom to change the

way they run their business - for example, shifting advertising strategies or adjusting product lines - but they do have a formula for success that the fra- nchiser has worked out. “In fact”, says one writer, “the secret to success in franchising is following the formula precisely.....Successful franchiser claim that neglecting to follow the formula is one of the chief reasons that granchisees fail.

Franchising is based on a continuing relationship between a franchiser abd a fran- chisee. The franchiser provides valuable services such as market research, a proven busi- ness system, name recognition, and many others; in return, the franchisee pays a percent- age of sales to the franchiser as royalities and agree to operate the outlet according to the franchiser’s system. Because franchiser develop the business systems their franchisees use and direct their distribution methods, they maintain substantial control over their fra- nchisees.Yet, this standardization lies at the core of franchising’s success as a method of distribution.

Types of Franchising

There are three basic types of franchising: tradename franchising, product distrib- ution franchising, and our franchising. Tradename franchising involves a brand name as True Value Hardware or Western Auto. Here, the franchise purchases the right to use the franchiser’s tradename without distributing particular products exclusively under the franchiser’s name. Product distribution franchising involves a franchiser licencing a franchisee to sell specific products under the franchiser’s brand name and trademark through a selective, limited distribution network. This system is commonly used to market automobilies (Chevrolet, Oldsmobile, Srysler), gasoline product (Exxon, Sunoco, Texa- co), sift drinks (Pepsi-Cola, Coca-Cola), bicycles (Schwinn), appliances, cosmetics, and other products. These two methods of franchising allow franchisees to acquire some of the parent company’s identity.

Pure (or comprehensive or business format) franchising involves providing the franchisee with a complete business format, including a licence for a tradename, the pro- ducts or services to be sold, the physical plant, the methods of operation, a marketing str- ategy plan, a quality control process, a two-way communications systems, and the neces- sary business services. The franchisee purchases the right to sell all of the elements of a fully integrated business operation. Pure franchising is the most rapidly growing of all ty- pes of franchising and is common among fast-food restaurants, hotels, business service firm, car rental agencis, educaional institutions, beauty aid retailers, and many others. Al- though product and tradename franchises annually ring up more sales than pure franchis- es, pure franchising outlets’ sales are growing much faster.

The Benefits of Buying a Franchise

A franchise gets the opportunity to own a small business relatively quickly, and, because of the identification with an established product and brand name, a franchise oft- en reaches the breakeven point faster than an independent business would. Still, most new franchise outlets don’t break even for at least six to eighteen monts.

Franchisees also benefit from the franchiser’s business experience. In fact, experi- ence is the essence of what a franchisee is buying from a franchiser. Many entrepreneurs go into business by themselves abd make many costly mistakes. Given the thin margin for error in the typical startup, a new business owner cannot afford to make many mistak- es. In a franchising arragement, the franchiser already has worked out the kinks in the system by trial and error, and franchises benefit from that experience. Gary Mandichak, owner of a successful Petland franchise says :”(Franchisers) have the experience, they know what works and what doesn’t, and they know what’s happening in the market.”

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Franchisees also derive a great deal of satisfaction from their work. According to a recent Gallup survey of franchise owner, 82 percent of franchisees said they were "so- me-what satisfied"to "very satisfied" with their work. Plus 75 percent said they would purchase their franchises again if given the opportunity (compared to just 39 percent of Americans who say they would choose the same job or business again.) . Another survey reported that 94 percent of franchise rated their operations as "very sucessful" or "succes- sful".

Before jumping at a franchise opportunity, an entrepreneur should consider caref- ully the question:"What can a franchise do for me that J cannot do for myself?" The ans- wer to the question will depend on the particular situation and is just as important as the systematic evaluation of an individual franchise opportunity. After careful deliberation, a franchise may conclude that the franchise offers nothing she could not do independently; on the other hand, it may turn out that the franchise is the key to success as a business owner. Franshisees often cite the following advantages.

How to Buy a Franchise

The UFOC (Uniform Franchise Offering Circular) is a powerful tool designed to help would be franchiser avoid dishonest franchisers. The best defences a prospective en- trepreneur has against unscrupulous franchisers are preparation, common sense, and pati- ence. By investigating throughly before investing on franchise, a potential franchisee eli- minates the risk of being hoodwinked into an investment decision helps a potential franc- hisee avoid being taken.

The president of a franchise consulting firm estimates that 5 to 10 percent of fran- chisers are dishonest,"the rogue elephants of franshising". Potential franchisees must be- ware. Because dishonest franchiser tend to follow certain patterns, well-prepared franc- hisees can avoid trouble. The following clues should arouse the suspicion of an entrepre- neur about to invest a franchise:

- Claims that franchise contract is a standard on and that "you don't need to read it."
- A franchiser that fails to give you a copy of the required disclosure document at your first face-to-face meeting.
- A marginally successful prototype store or prototype at all.
- A poorly prepared operations manual outlining the franchise system (or no manual for system) at all.
- Oral promises of future earnings without written documentation.
- A high-franchisee turnover rate or a high-termination rate.
- An unusual amount of litigation brought against the franchiser.
- Attempt to discourage you from allowing an attorney to evaluate the franchise contract before you sigh it.
- No wrutten documentation to support claims and promises.
- A high-pressure sale-sign the contract now or lose the opportunity.
- Claiming to be exempt from federal laws reqiring complete dislosure of franchise details.
- Get-rich-quick schemes", promises of huge profits with only minimum effort.
- Reluctance to provide a list of present franchisees for you to interview.
- Evasive, vague answers to your questions about the franchise and its operation.

Not every franchise "horror story" is the result of dishonest franchisers. More oft- en than not, the problems that arise in franchising have more to do with frabchisees who buy legitimate

franchisees without proper research and analysis. They and up in business they don't enjoy and that they are not well situed to operate.

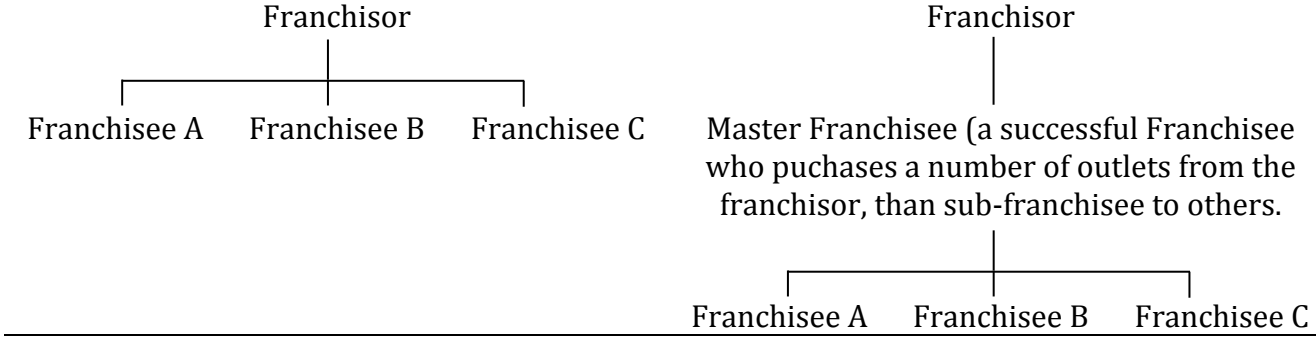
By any standard, successful franchising is one of the most effective and efficient methods for market expansion. The concept is an old one: using other people's resourc- es, financial and human, to expand the business operation. From the point of view of the franchisor, the growth rate can soar in a very short time — months or even weeks. Franchising often proves a better way of expanding than increasing a company's own branch operations because a franchise transforms an employee (manager) into an in- dependent franchisee. He or she is not responsible to a superior; rather, perfor¬mance is ju- dged in the marketplace — a primary goal of the entrepreneurial orienta¬tion to business.

Any business can be franchised, although entrepreneurs in the recent past have found services, especially food services and hospitality industries, and retail more sui- table than manufacturing concerns. The fastest growing franchise operations today are in home care (maid services and house painting) and new automotive ser¬vices (new car dealers), which are enjoying about a 30 per cent growth rate.

Effective franchising takes two basic forms. One is the spin-off franchise, often called branchise (branch + ise). A branch operation, frequently one that is less profitab- le than anticipated, is offered to its manager (or others), who invests his or her own mon- ey in it but operates under the parent company's name. This form of franchising does not satisfy expansion goals (because the outlet already exists); nevertheless, it enables the entrepreneur to acquire a large sam of money immedi¬ately and thus strengthens the com- pany's financial position.

The other form of franchising is what most people think of when they hear the word? A successful operation sells the right to operate an identical outlet under the origi- nal's name. For example, Michael Bregman, a graduate of the Harvard MBA program, opened a store called Mmmuffins in Toronto in December 1979. His "mmmar-vellous mmmuffins" proved popular, and through franchising the firm has become one of the largest and fastest growing companies in North America, with virtually identical outlets all over the continent. The standardization is part of the appeal anywhere customers go, the minute they choose Mmmuffins, they pretty well know what their money will buy. No surprises - they get what they expect. Franchising has become so popular that, like any growing business activity, it has evolved and expanded. Previously there were only the franchisor-franchisee operation, in recent years, some operations have expanded to three-tier relationships. A master franchi- see is a person who, after being a successful franchisee, purchases a number of outlets from the franchisor and then subfranchises them to others (see Exhibit 1.2.).

EXHIBIT 1.2. The Trend in Franchising



Source: International Trade Administration and the US Department of Commerce

What the Franchisor Sells

Marketing franchises is itself a challenge for the entrepreneur. What is being sold is not a product or a service but a package, a way of participating in a business that has proved a success. It is difficult to imagine anyone launching successful franchises who does not already have a successful operation. The most important assets in franchising are the name, the trademarks, and the methods of operation. For this rea¬son, the would-be franchisor should have several (at least two) branch operations to be used as models in designing a franchise package.

In addition to the franchisor's own success, that package contains a number of elements, some explicit and some implicit. The following pages describe some of them.

The Disclosure Statement

Selling franchises requires disclosing information. Generally wrapped in a carefu- lly prepared, attractive format, the disclosure statement is designed to attract potential fra- nchisees to consider the purchase; it is also needed to satisfy legal requirements. The disclosures include:

The Franchising Fee. The franchisor can ask for virtually any fee that he or she feels appropriate. But a fee that is fair to both parties will help attract desirable franc- hisees. The proper way to set a franchise fee is to recognize the relationship between the fee and the expected residual income. For example, suppose a standard-sized operation of a particular outlet can be estimated to have a residual before capital charge of $40,000 per year. If the required return on investment is 25 per cent, a franchising fee of $100,000 is not uncommon. If the fee is to be paid over a period of several years (a common arrange- ment), one should, of course, use the present value of the aggregate residual income when calculating.

A Clear Statement of Other Required Investments. The other investments required of a franchisee may include building costs (which vary with location, size, kind, leasehold improvements, and so on); the purchase or rental of production (operating) equ- ipment; payments for building improvements, fixtures, furni¬ture, supplies, engineering and architecture fees, permits, and promotion; the provision of working capital; and the payment of preopening expenses, advance rent, and other incidental expenses.

The Royalty and How It Will Be Calculated. Unlike a corporate profit centre, where managers are measured by the bottom line, a franchised operation truly measures the franchisee's performance on the basis of sales. The amount charged is normally 3 to 6 per cent of sales, payable monthly. (Recently, some franchisors have been calculating th- eir royalty payments weekly on the forecast sales but having them deductible when the franchisee completes its monthly transactions.) In setting the royalty, it pays for the fran- chisor to remember that this is a matter in which there is no room for the franchisee to ne- gotiate. Thus, the charge must be fair and attractive to would be franchisee. A reason- able way to determine what is appropriate is to work from the estimated bottom line (resi- dual income), taking into consideration that royalty is a variable cost inescapable under any cir¬cumstances.

What the Franchisor Offers Franchisees. Normally a franchisor is obliga- ted to offer at least the following:

- Training. The franchisor must provide a training program covering all aspe- cts of the business operation, such as operating policies and procedures, human resou- rces policies (for example, dress policies, hiring and training procedures, and employee benefits), operating procedures, operating menus including accounting packages, selling, administration and merchandising, management control systems, and all other

operation details. Prospective franchisees must also know about the length of the training period and where the required training takes place.

- Technical information and operation. For example, if the franchise is a pizza restaurant, the franchisee must be provided with recipes and given opportuni¬ties to learn how to bake and prepare foods, using proven successful methods.
- Operating manuals. The franchisor should provide the franchisee with operati- ng manuals that contain essential information concerning the company's policy, operating standards, and other matters that will contribute to the franchise's success.
- Trademarks. Franchisees are required to use trademarks, designs, and other-market and operational identifications of the franchisor.
- Planning, design, and construction. The franchisor is obligated to coordinate the planning, design, and construction of the franchisee's premises.
- Real estate. The franchisor is required to assist the franchisee in selecting a location and negotiating the lease.
- Assisting the opening. For a period of two weeks to one month, the franchi¬sor should provide qualified personnel to assist the franchisee in opening the new operation.
- Continuing support. The franchisor should make available counselling and assistance from competent, friendly individuals.
- Purchasing. For items essential to operations, the franchisor often has reli¬able sources, which the franchisee may be required to use. In addition, the franchisor assists franchisees in all the areas of purchasing, including selec¬tion of equipment, fixtures, and other supplies that are not provided by the franchisor.
- Territorial protection. The franchisor must protect the franchisee's interest as if he or she were an integral part of the operation.
- Financial assistance. Although franchisors are not required to provide finan-cial assistance, it is logical for them to do so since the operation of a fran¬chise is really a joint venture.

Professionalism, Honesty, and Commitment

In addition to these matters, which are spelled out in the franchising agreement, a franchisee has an implicit right to expect that the franchisor is offering certain less defin- able factors. One is professionalism, in the sense of a smoothly run system. For example, franchisors must be geared to providing prompt service to franchisees. Indeed, professio- nalism is the key factor in franchising. Many franchise operations are successful because of the entrepreneur's determination to give an old-fashioned business a professional tou- ch.

Professionalism presupposes honesty. Franchisors must give franchisees their money's worth. They must honour the franchising agreement absolutely, making no attempt to take advantage of flaws or manipulate clauses to their own advantage.

Business ethics must be observed with human compassion. Above all, franchisors must commit themselves to the success of the franchise operation. According to the con- tractual agreement, the franchisee cannot vary the outlet's products, merchandise, or services. Fairness demands that franchisors assume the responsibility of continuing efforts in R&D, product innovation, improvements in technology and production, advertising and promotion, and main-lenance and improvement of standards.

Last, but not least, the franchisor should avoid the use of fine print in the franhise agreement. The best way of drafting a franchise agreement is to seek profes¬sional help; only a competent lawyer specializing in franchise businesses should be angaged. If possi- ble, the agreement should be made simple, with a minimum of legal and technical jargon. Alternatively, the franchisor must ask the potential franchisee seek a counsellor's help or at least explain to him,

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or her what is in the agreement. Although everyone should know how to read, not everyone can read properly.

Selecting Promoters

Franchising for the first time can be a difficult task for the entrepreneur. It is esse- n¬tially a marketing scheme, and aggressive marketing is often one of the keys to sucess. Engaging promoters is often necessary, in particular for selling the franchise package in the marketplace.

Unfortunately, not all promoters are equal. Consequently, selecting them is a task not to be underestimated. The criteria for competent, reputable promoters are the same as those for distributors and sales representatives. Promoters should themselves be entrepre- neurially inclined individuals. Track record is vital. So is honesty. No franchise system can be a good system if its promoter has a questiona¬ble background or a reputation of be- ing someone whose objective is to grab a fast buck and run.

Franchisees' Success

Clearly, success in franchising depends largely on the success of the franchisees. For an entrepreneur whose enterprise is maturing and who has worked out the system car-refully, the chances are fairly good. According to research findings, franchised operations have a higher success rate than independent smaller firms. Of the many reasons, the most important may be that the franchisee makes such a substantial financial commitment. A franchise fee of $50,000 to $500,000 is a real sacrifice for the purchase of the right to ent- er a particular form of business. Having made this kind of commitment, even the least motivated individuals will try to pull up their socks and protect their investment.

Franchising may also be filling a social need by providing a way of encouraging entrepreneurs. As Ibrahim puts it:

> *Franchising may be the answer to small-business problems and failure rate. Franchise operators have betlcr and wide management skills than non-franchised small-business owner/managers. This rinding underscores the role of the franchisor as a changing agent and training institution for "budding entrepreneurs."*

Konigsber points out, however, that only franchising through established franchis- ors has proven a success (about a 10 per cent failure rate). The failure rate for new unproved franchises that entered the marketplace in their early years of operation does not di- ffer from that of other small firms.

Trends Shaping Franchising

Franchising has experienced three major growth waves since its begining. The fir- st wave occured in the early 1970s when fast-food restaurants used the concept to grow rapidly. The fast-food industry was one of the first to discover the power of franchising, but other business soon took notice and adapted the franchising concept to their industri- es. The second wave took place in the mid-1980s as our notion's economy shifted heav- ily toward the service sector. Franchises followed suit, springing up in every services and real estate. The third wave began in the early 1990s and continues today. It is characteri- zed by new, low-cost franchises that focus on specific market niches. In the wake of maj- or corporate downsizing and the burgeoning cost of traditional franchises, these new fra- nchises allow would-be entrepreneurs to get into proven business faster and at low costs. These companies feature startup costs in the $2,000 to $250.000 range and span a variety of industries – from leak detection in homes

and auto detailing to care and the tile glazi- ng. Other significant trends affecting franchising include the following:

International opportunities. One of the biggest trends in franchising is the internationalization OG American franchise systems. Increasingly, franchising is becoming a major ex- port industry for the United States. Over the past decade, a growing number of franchises were attracted to international markets to boost sales and profits. About 11 percent of U.S. franchisers have outlets in other countries, and another 28 percent expect to establish franchises abroad by 2000. Canada is the primary maket for U.S. franchisers, with Mexico, Japan and Europe following (see Table 1.3.).

EXHIBIT 1.3. The Top International Franchise Markets

No#	Country	Total Value of Goods and Services Sold by U.S. Franchisers (in million of $)
1	Canada	$40,749
2	Mexico	$3,500
3	Japan	$1,890
4	United Kingdom	$975
5	Germany	$900
6	Switzerland	$870
7	Brazil	$640
8	France	$580
9	Singapore	$440
10	Span & Italy	$350

Sources: international Trade Administration and the U.S. Department of Commerce

These markets are most attractive to franchisers because they are similar to the U.S. market with rising personel incomes, strong demond for consumer goods, growing service economies, and spreading urbanization.

Future growth is likely to occur in other countries as well. Because of its growi- ng midle class, favorable economic trends, and a recent free trade agreement with the Un- ited States, Mexico will become a popular target for franchisers. The Pacific Rim is anot- her area with high-growing potential.

Acquisition

For a mature enterprise, acquisition of (or merger with) one or more existing firms can be a fast and successful route to rapid growth. This strategy presents many chal¬lenges - not least the question of establishing a reasonable acquisition price and the probl- em of maintaining entrepreneurial spirit in the acquired firm - but, overall, acquisition has a number of distinct advantages over vertical growth undertakings. They include:

1. An immediate gain in market power by eliminating competition. In a market with a limited number of competitors, acquiring one of them can give a firm an immedia¬te rise in its market share. Say the marketplace has only ten competitors. If a firm that has 30 per cent of that market acquires a competitor with 20 per cent, the acquiring company has 50 per cent market share as soon as the deal is signed.
2. Benefit from management expertise and technological knowhow. The buyer of a company obtains not only its tangible assets but also its human resources and technology. This may be the reason acquisition experts often advise people to consider for

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purc- hase only those companies that are in the top 30 per cent of the market. (In other words, if the market has thirty companies in competition, the acquiring company should consider only the top ten of them.) It is these top companies that are most likely to have management expertise in manufacturing, distribution, and cost control and be highly competent in technology.

3. Immediate diversification. A company acquiring another whose products and /or services differ from its own immediately adds new lines that have already proven successful in the marketplace. Acquisition may also provide an opportunity to diversify geo- graphically. In other words, it may offer a market or territory expansion that would other- wise have been beyond the reach of the acquiring company.

All these reasons can be compressed into one simple statement: it is easier and of- ten i heaper to buy than to create a company. For this reason, entrepreneurs of enter¬prises that are reasonably well developed, even those who have not determined an acquisition strategy for the immediate future, should stay alert for acquisition oppor¬tunities. Although the acquiring firm often initiates acquisitions, many companies prompt their own pur- chase. Knowledgeable observers say the most frequent reason is corporate rationalizati- on; firms (often foreign-owned ones) seek to sell divisions that are unprofitable or divisi- ons that no longer lit the corporate strategy. The owner/manager of a small, established company may want to sell for reasons of it Young, growing firms may sell control in ord- er to expand rapidly. Such chances should be investigated by firms with enterpreneurial spirit.

Paying for an Acquisition

In considering acquisition of another firm, the entrepreneur should remember that one need not pay 100 per cent cash for it. Consider the following possibilities (in each ca- se, Company A acquires Company B):

- After acquisition, a new entity. Company C, is formed, although it will do business under the name of Company A. New shares, representing stock in Company C, are issued, and the purchase money is used to pay for the acquisition. Company A issues bonds or preferred shares; the proceeds are used to acquire Company B.
- Company a raises funds for the acquisition from its own shareholders by using additional common stock and either placing it privately or going public. (The difference is discussed later in this chapter.)
- Company a uses Company B's tangible assets as security for debt financing of the acquisition.
- Other ways to raise funds for financing acquisition for expansion include selling some of the company's assets (such as land and building), licensing, and franchising.

Acquisition Price

Determining an appropriate price for a company is a real challenge. Since no real market exists, the buyer and seller have to create a value as a basis for negotiation of a price that each is willing to accept. A seller actively seeking purchase will usually have a prospectus that includes a price tag. It may be realistic or way out of line. A willing seller will also make financial records available. These should, however, be checked, if possible with audited financial statements. Even audited statements may not give the whole sto- ry; for example, they may lack details on dividend payments, assets assigned for particul- ar purposes, market potential, or major investment payoffs. Nonetheless, a potential buy- er who has audited financial statements at least knows the company's dividend paymen- ts, earning records, financial state, and, in particular, asset value. With this financial info- rmation, the potential buyer can create a

hypothetical value of the firm to his or her situa- tion and then assess other available information, making it possible to enter negotiations with the seller.

EXHIBIT 1.3. Sample Calculation of the Value of a Prospective Acquisition

	Balance Per Sheet	%Assigned	Revised Value
Cash	$26,000	100	$26,000
Marketable Securities	$50,000	100	$50,000
Accounts Receiveable	$265,000	80	$212,000
Inventories	$512,000	60	$307,200
Machinery & Equipments	$62,000	40	$24,800
Good Will	$100,000	To be Determined	To be Determined
Leaseholders Improvement	$23,000	20	$4,600
Total	$1,038,000		$624,600

Source: International Trade Administration and the U.S. Department of Commerce

One Method of Valuation

The following is a general approach to such valuation. Assume the selling company has an asking price of $1 million for 100 per cent of its shares; to back this pri- Ce, it makes available the financial information shown in the first column of Exhibit 1.3. The prospective buyer takes these balance sheet numbers and figures adjustments: basically how much each listed asset would be worth in his or her situation. Using percentages (column 2) to calculate this and setting aside for the moment the value of good will (see the next subsection), the would-be purchaser arrives at almost $625,000. If he or she is willing to accept the seller's $100,000 valuation of good will, the total estimated value is $725,000.

A check on these calculations is available in the form of the standard i rice/ea- rnings (P/E) ratio. For this kind of business, it is about six times earnings. According to the company's records for the past five years, earnings have been about $135,000. So on that basis, the value should be about $810,000.

Based on these simple calculations, the value of the company is between $725,000 and $800,000. With an asking price of $ 1,000,000, it should be possible to ne- gotiate a deal.

This illustration is, of course, totally over simplified. It indicates, however, that it is possible to start with standard financial information and derive a value that can guide negotiation. The most important thing to keep in mind is that in the world of business ev- ery¬thing is for sale; the only difference is price, and it can be negotiated.

Summary

Virtually all expansion in business is driven by entrepreneurial desire, but it may be prompted by a defensive motive, by the firm's objective of growth, or by market pow- er and the profit motive. The common forms of expansion, other than internal vertical gr- owth, are franchising, acquisition, and exporting.

Many entrepreneurs are able to benefit from franchising, a form of doing busines that allows them to build their enterprises using other people's money and resources. As a franchisor, the entrepreneur must remember that franchisees can members of the enterprise team. He or she should always keep their interests in mind, espcially by exercising professional discipline and observing business ethics.

Acquisition provides a rapid means of expansion. Through it, a firm can benefit by buying a company's management expertise and technology, which otherwise lit not be readily available.

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Above all, acquisition can also provide the company with the eliminati- on of competition, and thus a gain in market power, as well as lediate diversification. Experts advise that an acquired firm be in the top 30 per cent of its industry because such a firm generally has more management knowhow and better distribution systems and cost control than less successful firms. On the other hand, if the selling firm does not have management expertise, the buyer should have its own team ready to move into the acquired company immediately after com¬pletion of the sale. Similarly, a growing company ar- med with management expertise may find the purchase of a failing firm profitable and challenging. However, a failing company requires examination that is even more rigorous than the careful consider¬ation that must be given any potential acquisition. Of the many issues involved in acquisition, maintaining a high level of entrepreneurial spirit should be one of the major concerns of the acquring company.

Notes

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