

# Status of Franchise Businesses and the Conditions for Success

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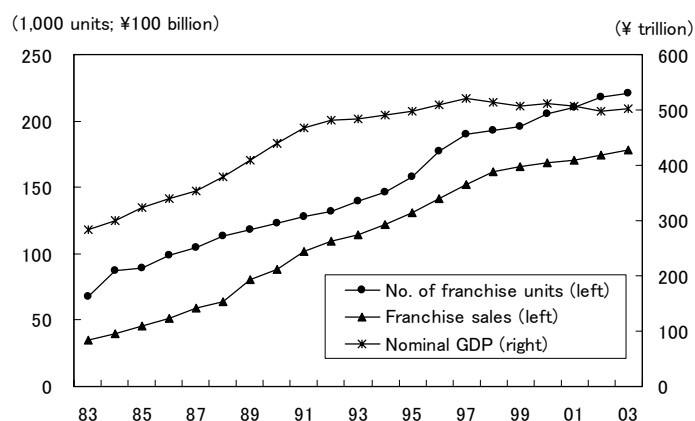
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## 1. Franchise Businesses Face Unexpected Difficulties

Franchise chains (FC) were introduced into Japan in the early 1960s. In franchising, the franchisor agrees to let the franchisee (franchise business or member) use its trademark and business system, and in return usually receives an initial fee and ongoing royalties. The franchisor provides extensive support to the franchisee at startup (such as in site selection and training and development) and on an ongoing basis (such as management guidance). Franchising is currently used in a wide variety of businesses, including convenience stores, fast food, dry cleaning, and even juku cram schools.

According to data compiled by the Japan Franchise Association (JCA) since 1983, franchising has been a growth industry, performing particularly well even during the economic recessions of the 1990s (Figure 1).

Figure 1 Trends in Franchise Units & Sales, and Nominal GDP



Sources: Japan Franchise Association, *JFA Franchise Chain Statistics*; Economic and Social Research Institute, Cabinet Office, *Annual Report on National Accounts*.

But despite the sustained success of the industry as a whole, not all individual franchise members

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have been performing well.

A study by the National Life Finance Corporation Research Institute (*Panel Study Results for New Start-ups: 2004*), which tracks the performance of startup businesses from 2001, finds that 7.8% of non-franchise businesses had gone out of business by 2003, compared to an astonishing 14.4% of franchise members.

Moreover, using data from the Japan Franchise Association's web site, we calculated that while convenience stores have a failure rate comparable to ordinary businesses, three other main franchise categories have higher failure rates (Figure 2).

Judging from the relatively high failure rates, franchise members appear to be struggling harder than their image as a growth industry would suggest.

**Figure 2 Failure Rate of Franchise and Non-Franchise Businesses**

	Convenience store	Retail outlet	Service outlet	Food outlet
<b>Franchise units</b>				
No. of chains	13	22	29	51
No. of units	2,217	225	229	203
No. of failures	128	22	17	16
Failure rate	5.76 %	9.60 %	7.44 %	7.96 %
<b>Overall failure rate, by company size</b>				
1~4 employees	6.10 %	6.10 %	6.85 %	4.38 %
5~9 employees	5.34 %	5.34 %	5.54 %	4.06 %
10~19 employees	5.31 %	5.31 %	5.23 %	3.96 %
20~29 employees	4.80 %	4.80 %	4.62 %	3.73 %
1~29 employees	5.88 %	5.88 %	6.46 %	4.26 %
1~19 employees	5.91 %	5.91 %	6.50 %	4.28 %

Sources: Japan Franchise Association web site; Ministry of Internal Affairs and Communications, 1999 *Establishment and Enterprise Census*.

## 2. Personal Characteristics and Investment Motives

In view of the harsh conditions confronting franchise businesses, below we examine franchise owners from two perspectives: their motive for investing in a franchise, and present satisfaction regarding their business.

The following analysis examines individual data compiled by the NLFC Research Institute (*Survey of New Business Owners Who Lack Relevant Business Experience*) on the investment motives and satisfaction of franchise owners.

The survey covers all startups (franchise and otherwise) that were less than five years old when

NLFC loans were made between December 2001 and September 2002. The characteristics of owners are analyzed based on whether they had any relevant business experience.

According to the results, franchise members are strongly characterized by a lack of relevant experience—only 53.9% of members have such experience, compared to 83.7% of non-members. This result reflects one of the main appeals of franchising: “no experience necessary.” A slightly larger proportion of franchise members are college educated and male. However, we found few differences between the two groups in the age at startup and general work experience (Figure 3).

**Figure 3 Personal Characteristics of Members and Non-Members**

	Member	Non-member
Have relevant business experience	53.9 %	83.7 %
Ratio of women	12.7 %	14.4 %
Ratio of college graduates	39.4 %	33.5 %
Age at startup	41.6	41.5
Have work experience	98.4 %	98.0 %

Source: NLFC Research Institute, *Survey of New Business Owners Who Lack Relevant Business Experience*.

Regarding motives for investing in a franchise (Figure 4), the most common reasons are that “established business knowhow is provided” (45.3%), and that the franchise was an “appealing business” (31.3%). Interestingly, reasons usually thought to favor franchises such as “operations manual is provided” (17.3%) and “management guidance is provided” (14.0%) are relatively unimportant.

**Figure 4 Motive for Franchise Investment**

	Composition
Appealing business	31.3 %
Established business knowhow provided	45.3 %
Marketing plan provided	7.4 %
Purchasing, product development provided	27.2 %
Operations manual provided	17.9 %
Management guidance provided	14.0 %
Financing support provided	2.7 %
Other	12.9 %

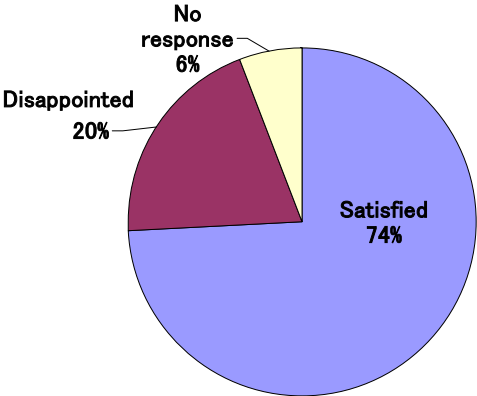
Note: Numbers do not add up to 100 due to multiple responses (up to two).  
Source: NLFC Research Institute.

Thus the decision to invest mainly emphasizes a favorable assessment of the franchise business, with less emphasis on franchising advantages such as management guidance and operation manuals. This result was rather unexpected.

### 3. Satisfaction With Franchise Investment

Regarding their investment decision, 74% of owners are satisfied by results, indicating that expectations are generally being met (Figure 5). However, another 20% express disappointment, suggesting that problems have arisen on one or both sides of the relationship.

**Figure 5 Satisfaction with Franchise Membership**



Source: NLFC Research Institute.

Regarding performance, non-members tend to be slightly more profitable (Figure 6). In addition, more non-members assess their performance relative to competitors as “somewhat good.” On the other hand, more members assess their performance relative to competitors as “good,” “somewhat bad” or “bad.” Thus franchise members do not necessarily perform better than non-members, and also tend to have more dispersed performance.

These results are consistent with the other NLFC survey results, and overturn the common notion that franchising provides an established business system that facilitates profitable and stable business performance. Part of the explanation lies in the difference in abilities, skills and motives of franchise members compared to non-members, and in differences in the quality of franchise systems.

**Figure 6 Performance of Franchise Members and Non-Members**

		Member	Non-member
Profitability	Profitable	56.5 %	60.2 %
Comparison with competitors:	Good	12.5 %	9.9 %
	Somewhat good	42.9 %	50.6 %
	Somewhat bad	33.1 %	28.3 %
	Bad	11.4 %	11.2 %

Source: NLFC Research Institute.

#### 4. Motivation and Business Success

For the 20% of franchise members who are disappointed, below we examine the causes of disappointment based on a comparison with satisfied members. As expected, franchise satisfaction is linked to business performance (Figure 7).

**Figure 7 Satisfaction and Business Performance**

	Satisfied	Disappointed
Profit-making	61.5 %	30.1 %
Loss-making	34.8 %	67.1 %

Source: NLFC Research Institute

Regarding the reason for investing, satisfied members tend to emphasize the “appealing business” aspect and that the “operations manual is provided” (Figure 8). On the other hand, motives emphasized by disappointed members are “marketing plan is provided,” “no purchasing or product development concerns,” and “management guidance is provided.”

Thus compared to satisfied members, disappointed members emphasize expectations of the franchisor’s support and management guidance. Although some expectation is understandable, disappointed members may have had excessive expectations that were unmet. Alternatively, a strong dependence on the franchisor suggests a lack of self-reliance as manager, which would lead to poor business performance and hence disappointment.

**Figure 8 Reasons for Investing in Franchise**

	Satisfied	Disappointed
Appealing business	34.1 %	24.7 %
Established business knowhow provided	45.6 %	46.6 %
Marketing plan provided	6.7 %	11.0 %
No purchasing, product development concerns	27.0 %	28.8 %
Operations manual provided	20.4 %	12.3 %
Management guidance provided	13.7 %	15.1 %
Financing support provided	3.0 %	1.4 %
Other	12.6 %	13.7 %

Note: Numbers may not add up to 100 due to multiple (up to two) responses.  
Source: NLFC Research Institute

Regarding motives for starting business, satisfied members tend more to emphasize reasons such as “to work independently,” “interested in business management,” and “to apply work experience,

knowledge or qualifications.” On the other hand, disappointed members tend to cite reasons such as “found no other appropriate work,” “wanted work unrelated to age or gender,” and “to apply hobby or special skills” (Figure 9).

With regard to performance, profit-making members tend to emphasize “interested in business management,” while loss-making members tend to emphasize “to serve society,” “wanted work unrelated to age or gender,” and “found no appropriate work.”

**Figure 9 Motive for Starting Business**

	Satisfied	Disappointed	Profit-making	Loss-making
To increase income	14.4 %	13.6 %	15.2 %	14.7 %
To work independently	18.0 %	13.6 %	15.8 %	16.3 %
Interested in business management	26.6 %	22.7 %	31.5 %	17.1 %
To commercialize own techniques, ideas	5.9 %	7.6 %	6.7 %	5.4 %
To apply experience, knowhow, qualifications	13.5 %	9.1 %	13.3 %	11.6 %
To apply hobby or special skills	1.8 %	4.5 %	2.4 %	2.3 %
To serve society	6.3 %	6.1 %	3.0 %	11.6 %
Wanted work unrelated to age or gender	3.2 %	6.1 %	1.8 %	7.0 %
Wanted more time, peace of mind	1.4 %	1.5 %	1.2 %	1.6 %
Found no other appropriate work	3.6 %	9.1 %	3.0 %	7.8 %
Other	5.4 %	6.1 %	6.1 %	4.7 %
Total	100.0 %	100.0 %	100.0 %	100.0 %

Source: NLFC Research Institute

From these results, positive motives seem to be associated with increased satisfaction, while disappointed members seem to have started business for rather simplistic reasons.

A related point is the decision regarding line of business, wherein satisfied members tend to emphasize applying work experience or skills and serving society, while disappointed members emphasize “applying hobby, skills, or qualifications,” “didn’t consider other alternatives,” and “seemed easy to do.” Members who failed may thus have made decisions too casually without considering their abilities and other important factors.

**Figure 10 Reasons for Choosing Business**

	Satisfied	Disappointed
Expected growth	25.6 %	23.3 %
To apply experience, skills from work	36.3 %	32.9 %
To serve community, society	15.9 %	6.8 %
To apply hobby, specialty, qualifications	8.5 %	12.3 %
Seemed easy to do	5.2 %	8.2 %
Didn't consider other alternatives	4.1 %	12.3 %
No response	4.4 %	4.1 %
Total	100.0 %	100.0 %

Source: NLFC Research Institute

## 5. Does Franchising Compensate for Lack of Experience?

Franchisors claim that their business support enables even people without business experience to easily start a business.

Franchise satisfaction appears to be related to work experience (knowledge, experience or knowhow accumulated prior to starting business)—only 42.4% of those without experience are satisfied, compared to 57.6% of those with experience. Thus having some relevant knowledge seems to work to advantage (Figure 11).

**Figure 11 Franchise Owner's Satisfaction and Previous Experience**

	Satisfied	Disappointed
Didn't have relevant experience	42.4 %	57.5 %
Had relevant experience	57.6 %	42.5 %

Source: NLFC Research Institute

However, compared to non-members, lack of experience among members has a smaller impact on profitability, as measured by the ratio of profit-making businesses (Figure 12). Thus franchise membership appears to significantly compensate for lack of relevant experience and knowledge.

**Figure 12 Previous Experience, Profitability, and Franchise Membership**

	Member	Non-member
Didn't have relevant experience	55.0 %	52.2 %
Had relevant experience	57.8 %	61.7 %

Source: NLFC Research Institute

Previous work experience may also affect pre-startup preparations and attitudes. Since 99% of both pleased and disappointed members have previous work experience, below we look more closely at the types of work experience.

With regard to whether they consciously studied or developed skills to prepare for starting business, a larger proportion of pleased members consciously worked, studied, or did both (Figure 13). As many as 42.5% of disappointed members did not consciously prepare for business. Thus it appears that preparing beforehand is an important factor in achieving satisfaction as a franchisee.

**Figure 13 Preparation for Starting Business**

	Satisfied	Disappointed
Consciously worked and studied	29.3 %	21.9 %
Consciously worked	30.7 %	26.0 %
Consciously studied	9.6 %	8.2 %
Did nothing in particular	29.3 %	42.5 %
No response	1.1 %	1.4 %
Total	100.0 %	100.0 %

Source: NLFC Research Institute

Moreover, among those who did not consciously prepare, satisfaction appears to be linked to differences in their motivation as business managers (Figure 14). Satisfied members strongly cite “business opportunity arose unexpectedly” and “unavoidable circumstances,” while over two-thirds of disappointed members cite “shift in perspective of life, society, or occupation.” Many disappointed members thus seem to have started business almost on a whim, without making any special preparation.



**Figure 14 Motive to Become Business Manager**

	Satisfied	Disappointed
Business opportunity arose unexpectedly	36.7 %	6.5 %
Unavoidable circumstances	30.4 %	22.6 %
Shift in perspective of life, society, occupation	32.9 %	67.7 %
No response	0.0 %	3.2 %
Total	100.0 %	100.0 %

Source: NLFC Research Institute

Given that experience is important for starting a business, below we look at the most useful types of experience by examining the deficiencies of managers.

A larger proportion of satisfied members refer to a deficiency in “knowledge of accounting, personnel management, taxation, and legal matters,” while disappointed members emphasize deficiencies in “network of personal contacts and business partners” and “marketing strategy and knowledge” (Figure 15). Accounting and related matters can be learned through seminars and textbooks, or outsourced to specialists. On the other hand, networking, sales strategy and marketing knowledge are intangible assets accumulated over many years of work experience and interactions, and represent the bedrock of business. Thus prior to starting a business, diligent preparation of networks and marketing strategy are vital to success.

**Figure 15 Deficiencies as Manager**

	Satisfied	Disappointed
Knowledge or skills of product, service	7.0 %	9.6 %
Knowledge of industry, business practices	11.5 %	11.0 %
Knowledge of marketing strategy	11.5 %	15.1 %
Knowledge of accounting, personnel, taxes, laws	35.9 %	28.8 %
Network of contacts and business partners	9.3 %	17.8 %
Knowledge of business permits, official procedures	2.6 %	1.4 %
Other	8.1 %	4.1 %
No deficiencies	10.4 %	9.6 %
No response	3.7 %	2.7 %
Total	100.0 %	100.0 %

Source: NLFC Research Institute

Generally, a decisive factor in starting business is the availability of financing (Figure 16). Here we find that disappointed members have a higher self-financing ratio as well as larger total startup capital. Perhaps their financing edge makes them less rigorous in their decisions on

buying a franchise, choosing the industry, and managing the business. It may also help explain why many were motivated to start business to make use of hobbies or skills.

**Figure 16 Startup Financing**

	Satisfied	Disappointed
Own funds	¥4.90 mil.	¥5.66 mil.
Total initial investment	¥16.74 mil.	¥17.40 mil.
Self-financing ratio	29.2 %	32.5%

Source: NLFC Research Institute

**6. Management Resources and Support Necessary for Success**

Regarding management resources necessary to successfully sustain franchises, satisfied franchise owners tend to emphasize quality of employees and sales ability, while disappointed owners emphasize financial strength (Figure 17).

**Figure 17 Strengths Leading to Business Sustainability**

	Satisfied	Disappointed
Technical ability	23.0 %	20.5 %
Planning ability	21.5 %	24.7 %
Sales ability	36.3 %	26.0 %
Quality of employees	49.3 %	32.9 %
Cutting-edge facilities	5.2 %	4.1 %
Coordinating ability	10.0 %	8.2 %
Financing ability	7.8 %	13.7 %
No deficiencies	22.2 %	21.9 %
No response	2.6 %	9.6 %

Note: Numbers may not add up to 100 due to multiple (up to two) responses.  
 Source: NLFC Research Institute

Franchise businesses flourish in labor-intensive industries such as retail, services, and restaurant and fast food. Moreover, since operations are standardized, franchise managers can best exercise their skills in the area of personnel management. Thus managers who stress employee quality and training can boost performance and achieve satisfaction. Moreover, sales strength is vital for franchise success, since consumers are their main customers.

As a growing number of people start new businesses, satisfied and disappointed members alike

agree that investment, loan, and guarantee support is the most effective measure (Figure 18). Again, satisfied members tend to emphasize human resource matters such as hiring and training personnel, and entrepreneurial education for young people.

By performance, while profit-making members emphasize support for technical R&D, no other significant differences are seen overall.

**Figure 18 Support Measures Regarded as Effective**

	Satisfied	Disappointed	Profit-making	Loss-making
Technical R&D	8.5 %	13.7 %	11.5 %	7.3 %
Tax, accounting, personnel	28.5 %	20.5 %	27.0 %	27.2 %
Marketing, sales channel development	29.3 %	37.0 %	27.0 %	35.8 %
Investment, loan, guarantee	66.3 %	71.2 %	68.0 %	70.9 %
Recruiting, T&D	25.2 %	15.1 %	27.5 %	19.2 %
Enlightenment activity, event	3.3 %	1.4 %	3.0 %	2.6 %
Entrepreneurial education for youth	12.2 %	8.2 %	10.5 %	12.6 %
Nothing	1.1 %	2.7 %	1.0 %	1.3 %
Other	2.6 %	0.0 %	2.5 %	0.7 %
No response	1.9 %	4.1 %	2.5 %	0.7 %

Note: Numbers may not add up to 100 due to multiple (up to two) responses.  
 Source: NLFC Research Institute

**7. Conditions for Successful Franchise Management**

Thus far, we have compared successful and unsuccessful franchise members in terms of motives for investing in a franchise, motives for starting business, reasons for choosing the business, and management strengths. Based on this analysis, we present four conditions for successful franchise management.

First, prospective franchise owners should choose a business that utilizes their accumulated knowledge and experience. Although franchisors claim that people with no previous experience can become successful franchisees, lack of experience has distinct disadvantages. People thus need to choose a business related to their previous experience as much as possible. Moreover, once they decide to start a business, they need to consciously prepare even while working at their present job.

Second, they need to be committed to the business. Questionable motives such as “didn’t consider any alternatives” or “to apply hobby or skills to work” will lead to regrettable outcomes. Among disappointed members, common complaints are “work hours increased” and “work was

unfulfilling.” Convenience stores are a typical case where work hours and work days cannot be freely changed. Moreover, the operations manual increases the amount of menial tasks. Without the commitment and physical toughness to withstand the rigorous demands of work, owners are sure to be disappointed by the outcome.

**Figure 19 Disadvantages of Becoming Manager**

	Satisfied	Disappointed
Lower income	46.3 %	48.1 %
Longer work hours	42.6 %	29.5 %
Abilities under-utilized	11.1 %	9.3 %
Not fulfilling	31.5 %	20.0 %
Obligation to employees, partners	16.7 %	37.3 %
Other	16.7 %	13.9 %
No response	5.6 %	2.9 %

Note: Numbers may not add up to 100 due to unlimited multiple responses.  
 Source: NLFC Research Institute

Third, personal relationships matter. While financing is a major challenge for startups, successful franchise owners emphasize hiring and training personnel, and claim that their strength lies in the quality of employees and sales ability. All of these factors pertain to human resources. Since franchise businesses are mostly consumer-oriented and labor-intensive, people who decide to invest in a franchise must enhance their communication skills so that they can properly manage employees and interact with customers.

The final point regards the selection of franchisor. The business system and support provided by different franchisors vary widely. Many franchisors who lack the necessary business expertise disappear from the market in a short time. According to our own study, in the 13-year period from 1990 to 2003, the failure rate among franchisors was extremely high at 70%. Even with ample startup capital and strong motivation, franchise owners who choose the wrong franchisor can still suffer disastrous results. Thus prospective owners must make sure that the franchisor they choose has a reliable business system, financial condition, and type of management guidance.