Ripple effects of a recession on the franchise market

By Sasha-Lee de Bod

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The recent South African recession caused a recurrent cycle between three franchise stakeholders, namely the franchisor, the franchisees (new and existing) and suppliers/service providers.

A recession influences the entire franchise uptake market, which starts with the franchisor supporting existing franchisees and recruiting new franchisees, which is influenced by existing franchisee performance and economic conditions, influencing suppliers and service providers. This ultimately impacts consumers and their buying power and behaviour, which in turn affects the entire network. Thus, a recession causes a ripple effect in the franchise market.

Financial performance

The franchisees' existing financial performance will be influenced due to a decline in turnover, which leads to lower profits. Marginal franchisees will suffer the most from the recession, as this may lead to negative financial performances or even bankruptcy and dissolution of franchise agreements if the situation persists. In the market, we have observed that this leads to the tendency to cut prices to reinstate some loss of sales during this period – consumer buying power and capabilities have been reduced therefore they are spending less.

This will negatively affect the both the franchisor and the suppliers. The franchisor's income, which consists of royalties from franchisees, will decline due to their financial performance. Franchisees will purchase less from suppliers due to a decrease in customer demand.

Credit impairment and access to additional capital

Credit impairment will be a factor, as the recession affects accounts receivable. Reduced revenues may result in delay in payment to suppliers and service providers, which will damage the franchised business's valuation of debt and the ability to service financial agreements. Additional financing from financial institutions will be hard to come by in these tough times and will even be harder to access if there is an undesired credit rating.

Employees

As turnover and profits decline, employee status, wages and benefits are negatively influenced. Franchisees will cut back on employees, i.e., freezing of hiring new employees and/or retrenchment of existing employees. This may result in productivity increase per employee due to longer hours and persistent effort to get the tasks done. Nevertheless, it will contribute to a decrease in staff morale and satisfaction.

Franchisors will advise against this, as they would like franchisees to maintain the current employee levels and keep the company afloat by implementing strategies such as reducing benefits and wages until the situation ceases. Ultimately releasing of employees will contribute to South Africa's high unemployment rate, which in turn will influence consumer buying power due to lack of income.

This is not only limited to the franchisees, the cycle will roll over to supplier and service provider businesses servicing the franchise market.

Franchisee recruitment

Franchisee recruitment will become a gruelling task for the franchisor. The current situation may discourage those with an entrepreneurial spirit to invest in franchises as this may be seen as a risky business investment due to economic uncertainty. Not only do potential franchisees not have the required funding requirements to invest in opportunities, they do not have access to the minimum cash requirement.

Financial institutions are discouraged to approve loan applications to new ventures due to current trading history and performance of current franchisees. They have stricter lending criteria, structures and policies that are being implemented in their institutions to mitigate profits declining in this economy. Apart from the financial restrictions to expand the network and acquiring new franchisees, it is difficult to find the right franchisee even in normal times. Recruitment has become even more demanding and tough for franchisors.

Franchisors are opening fewer outlets, therefore, it Influences suppliers such as equipment manufacturers, landlords and shopfitters.

Innovation, support and training

Due to the decrease in franchisee turnover, it is becoming more difficult for franchisors to support and train the franchisees effectively on an ongoing basis, as their royalties are used for this. The initial fees from new franchisees are extended to continuous research and development, this is now reduced and franchisors are forced to hold back on innovation of new products and service developments due to uncertainty in the market place and how consumers will perceive it.

Risk mitigating strategies

Franchisors will adapt risk mitigation strategies to assist franchisees in reducing overheads eg negotiating better rates from suppliers (which will benefit the franchise network but place the service providers and suppliers at a disadvantage).

Some of the larger franchisors may opt to absorb increasing costs at distribution level but this will influence their profitability and cannot be sustained indefinitely.

Marketing

Franchisees contribute a percentage of turnover to a marketing fund, which will be affected by the recession. Fewer marketing initiatives affect consumer confidence in the brand, thus leading to a decrease in spending behaviour.

However, a recession presents opportunities for the stronger franchise groups, such as:

• Mergers and acquisitions
• Acquire good staff
• Increase marketing efforts to strengthen brand and generate sales
• Give great service to differentiate from competitors

Conclusion

During a recession, each stakeholder in the franchise network needs to pull forces together and adapt risk management strategies to sustain operations until the economy stabilises. The strong brands will survive and prosper while the weak ones risk falling by the wayside.

ABOUT THE AUTHOR

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