PART EIGHT
Structures for growth

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How to franchise your business

8.1

Professor Roy Seaman at Franchising Development Services (FDS) looks at how franchising can put you on the fast track to growth

An increasing number of well-established and new companies are now giving serious consideration to the benefits of expanding their operations using the franchise option. Among the many advantages of franchising a business over opening a network of company-owned outlets are reduced costs, faster growth and a higher rate of dedication among personnel.

When franchising is well thought through, it can provide a perfect model for the owners of a business with genuine national or international potential, as well as an offer to investors who are seeking to emulate the success of what the originating franchisor is achieving. According to the latest NatWest/British Franchise Association (bfa) UK Survey, there are now 897 businesses operating franchised systems in the UK, which contributed £12.4 billion to the UK economy in 2010.

The bfa's director general Brian Smart adds: 'Franchising has demonstrated its inherent tenacity and stability, despite a tough climate. This means many more sustainable business start-ups and jobs have been created by franchising – further helping the UK economy get back on its feet.' The survey also revealed that compared to the recession in the early 1990s, fewer franchise businesses are trading at a loss. In 1990 only 70 per cent of all franchise businesses were profitable, but the figure today stands at 90 per cent.

Simultaneously, an ever-growing number of highly capable and competent individuals are looking to invest in owning and operating their own business under a franchise system. Therefore, in this pro-franchising climate, any successful business owner would be well advised to check out whether franchising is suitable for their business.

To do this, you must first understand whether your business is suitable for franchising. Does the business operate a proven concept that can be replicated nationwide? Have any teething problems been ironed out, and are all the systems and procedures in place? Is the business performing to replicable growth standards with a professional national-standard brand identity and corporate image?

Capital investment

Assuming your business has fulfilled these requirements, how do you go about franchising it? No short cuts should be entertained, as franchising only works where a company enters with the right levels of funding, management infrastructure and motivation. Where that exists, good franchise practices result. I suspect that many of those well-intentioned franchisors who fail have taken short cuts to franchising – trying to save money on the kind of professional consultancy which could have steered them away from miscalculations and injudicious moves.

During the early days of developing a franchise system, rather than a net flow of money coming into their business, the new franchisor needs to expect a net flow outwards. Support staff need to be paid and new franchise owners – also known as franchisees – recruited and trained. On average, franchise owners themselves cost between £5,000 and £10,000 each to recruit and will require substantial support while still generating little business and paying little by way of fees.

So how much capital is necessary for a prospective franchisor developing a franchise? The investment required will differ from industry to industry – a pilot scheme involving the opening a new retail outlet will cost much more than rolling out a franchise model for a 'man-in-a-van' operation.

Masterminding a professional infrastructure for franchising a business normally requires around £30,000 plus at least £20,000 for marketing, depending on the complexity of the business and the style and rate of expansion desired. A properly advised and constructed franchise development plan will normally have between two and four franchise owners operating within 12 months from such a budget.

Feasibility study

The first investment will be commissioning an evaluation analysis and outline franchise development business plan from a well-established franchise consultancy. In many ways this is the most important investment in the process of setting up a franchise. The study's twin goals are to analyse the business and its market, and to identify what modifications may be required to ensure its smooth franchise development work programme.

The work must identify the operation's systems, corporate strengths and altogether cover the 21 elements of a genuine business format franchise. There will be aspects that are vital to the success of the business which must be built into the franchise concept, there will be elements that must be removed or amended to ensure that the franchise relationship is fair and profitable, and there will be elements that will not affect the franchise either way – the work will recommend whether the latter be included or removed depending on the competing costs involved.

Franchise action plan

Provided that the business has genuine growth potential, has good profit margins and can be taught to others, there is normally a way to proceed. Then a franchise action plan must be developed and implemented. This will:

- identify the competition;
- identify the ideal franchise expansion method (job, management, retail) or if going global (area development, direct franchising, multi-units, defined territories);
- analyse and define the franchise package component needs;
- ascertain the true market value of the franchise package content;
- set out a detailed franchise development business plan;
- develop the requirement of an initial training programme capable of fully preparing a franchise owner for the launch of the business;
- set out ongoing support structures such as a franchise owner essential support services telephone helpline, intranet facility, marketing support possibly including personalized websites etc;
- identify financial support packages to assist franchise owners to meet the investment requirement and also tailored insurance packages.

For a business seeking to obtain membership of the bfa – and this is certainly recommended – the construction of the franchise must be performed with the requirements of its charter in mind.

Pre-sale documents

With the franchise package in place, now comes the time to set it down in print. There are a number of UK lawyers specializing in franchising, many of whom are affiliated members of the bfa who will be able to produce the appropriate franchise agreements.

Additional documents must also be designed and developed, including franchise owner manuals, marketing and promotional materials; also, intellectual property rights need to be secured before the final document is produced, which is known as the franchise prospectus.

Recruiting franchise owners

Once the franchise package is in place, the process of building a franchise network can start. It is at this point that having the correct strategy is absolutely crucial to ensure the business gets off on the right footing, as Tony Urwin, FDS North Regional Director, states:

Franchisors must understand the importance of a well-managed recruitment programme. Carried out correctly, this establishes the basis of a high-quality and well-motivated franchise network. Done wrong, it can sow the seeds of a franchisor's undoing.

Frankly, the recruitment of suitable franchise owners is one of the most time-consuming aspects of any franchise development programme. A precisely targeted marketing campaign must be developed and implemented and the results measured. Once the telephones start ringing and the inbox starts filling, each and every lead must be systematically and promptly followed up.

The franchisor should take the details and answer the questions of every enquirer and – subject to initial screening – send the documentation, usually a prospectus. Returned application forms should be processed, and subsequent interviews scheduled and conducted. The marketing efforts, screening process, relationship management and data collection involved can exhaust even the most committed franchisor.

Outsource or do it yourself?

Developing a franchise is a very challenging undertaking, and only advisable if you are armed with a wealth of practical experience and the best franchise consultant that you can find. You must engage those with a proven experience and the best track record of success. This would seem obvious, but it is surprising how many emerging franchisors consult help only after expending a substantial investment on failing to build a workable franchise package themselves. Accessing the franchise wisdom of more experienced parties is an insurance against having to retread these steps further down the line – a costly and difficult endeavour if franchise owners are already signed up, especially if the franchise agreement is far from what it should be and needs amending.

There is a whole host of weaknesses that can be easily avoided. These include lacking in professional presentation and behaviour, weak brand profile, undercapitalization, weak infrastructure for initial and ongoing training, lack of commitment to creating a genuine business format franchise, unproven systems, lack of continuity in key management and lack of effective communication with franchise owners.

'Overall success in franchising is not based on a small number of factors, but a combination of many criteria – applied at the right time, in the right way and in the right place', emphasizes FDS southern regional director Gary Rigby. 'Those who win in the long term do not do so by chance. They recognize the criteria that are most important, apply them and keep striving to deliver their best for both franchise owners and customers. Above all, there must be a balance of interests between franchise owners and franchisors where both parties to the partnership win unequivocally.'

Franchising does provide an ideal strategy for owners of successful businesses to follow. However, there is a well-trodden pathway and the key to success is to ensure that your franchise consultant knows exactly how to unlock the doors to your franchise development success.

Professor Roy Seaman, CFE, QFP, has been a tireless ambassador and highly regarded speaker for franchising since 1981, when he founded Franchise Development Services. Roy has helped to mastermind franchise consultancy advice and guidance to hundreds of British companies and has assisted many people to own a franchise.

For further information about franchising: website: fdsfranchise.com, TheFranchiseMagazine.net; tel: 01603 620301; e-mail enquiries@fdsltd.com

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Licence to grow

8.2

Mark Anderson discusses IP licensing as a route to growth

Intellectual property (IP) can be a company's most valuable asset. Astute management of IP can be more important to a company's long-term success than the management of conventional assets such as buildings and stock-in-trade, or even (dare one say it aloud) employees. It can also be a waste of money and resources. IP only has value if it is protected and managed in support of a clear business strategy. IP licensing (in-licensing or out-licensing) can make a valuable contribution to a company's growth strategy.

Bill Gates famously started his business by licensing, rather than assigning, the copyright in MS-DOS to IBM. This enabled him to grow his business by licensing the same software elsewhere.

The Nutrasweet Company, as it is now called, had a two-pronged IP strategy for protecting their artificial sweetener, aspartame. Initially, they protected the product with patents, but patents only last for 17 or 20 years. By the time the patents expired in 1992, they had developed a trade mark licensing programme. The company maintained its market-leading position by licensing diet drink manufacturers to use the name *Nutrasweet*®, which was trusted by consumers. More recently, other sweeteners, with their own brand names, eg *Splenda*®, have taken some market share. Take a look at the small print on the label, next time you buy a can or bottle of Diet Coke®. Some contain *Nutrasweet*® and others contain *Splenda*®. In both cases, the trade mark is being licensed to add value to the ultimate product.

IP can benefit growing companies

You don't need to be a large company such as Microsoft or Nutrasweet in order to benefit from IP. Last year, my firm helped a micro-business – a carpentry company that designs and makes five-bar gates for wildlife parks. The company supplied gates for one project, and later discovered that the customer had commissioned someone else to make gates to the same design for a second project. By asserting copyright and design rights, we were able to get the company compensation from the customer. Our client managed to maintain a business relationship with the customer and received further orders for carpentry products.

In all of these examples, the management of IP – copyright, design rights, trade secrets, patents and trade marks – has been an important part of a larger business strategy.

IP is not for everyone

However, IP management is not for everyone. Business managers do not need to become experts in the intricacies of patents and other IP – that takes years for even the brightest patent attorneys to learn – but they do need to able to engage with a certain amount of legal detail. This is necessary in order to take good strategic decisions about the IP, to give clear instructions to IP professionals and to negotiate advantageous terms in IP agreements.

Even more fundamentally, the business needs to be one that can take advantage of IP assets. Some small businesses are based on a very simple business model: make or buy-in goods at one price, and sell them at a higher price. The business may be managed by a single individual who spends their time in day-to-day trading activities, and who is not well equipped for sophisticated business planning. In such cases, investing in IP may be an unprofitable diversion from the core activities of the business. The author has encountered too many small businesses that think IP licensing is a quick, cheap way of expanding their business beyond its natural limits, or of shoring up a failing business. Some franchise propositions, aggressively marketed in the back pages of national newspapers, have fallen into this category.

You don't need to be a technology business to benefit from IP

Other businesses are better equipped to take advantage of the opportunities that IP may bring. A common misconception is that you need to be in a 'technology' business in order for IP to be valuable. If you are in a technology business, almost certainly IP will be important, but the reverse is not true.

Let's take some practical examples. Franchising was mentioned earlier. The most successful franchises are heavily dependent on IP protection and licensing. Typically, the franchisee obtains a trade mark licence, allowing them to use the franchise brand. They usually obtain a know-how licence, which gives them controlled access to a bible of confidential information about how to run the franchise. There may be a copyright licence in respect of artwork and marketing materials. Less frequently for high-street franchises, there may also be a patent licence, to allow use of patented technology.

A more technology-focused example is software licensing. One of our clients develops computer games, which it licenses to large gaming and betting companies for use on their websites. Another of our clients in-licenses third-party software, bundles it with its own software, and licenses the bundled package on to customers.

Skills required for managing IP transactions

What are the skills that are required for successful IP licensing? For present purposes, we are referring to the business skills required of a commercial manager, and not to the

more specialist skills of a contract lawyer or patent attorney. You will certainly need professional advice on IP transactions, but you cannot just leave the entire project to the advisers. Ultimately, a commercial manager should take the business decisions, lead commercial negotiations and take commercial responsibility for the deal.

A good starting point is to have a basic understanding of what IP is, and how it can be traded – usually by an *assignment* (outright transfer of ownership) or *licence* (permission to use, with ownership remaining with the licensor). An alternative business model is not to trade the IP, but instead to maintain it as an in-house resource, and as the basis for legal action against infringers if required. Simple guides to IP can be found on the UK Intellectual Property Office website, and the author of this article runs courses on IP subjects for non-lawyers.

It is useful for the commercial manager to become familiar with licensing practice in the relevant industry sector on issues such as whether to grant exclusive or non-exclusive licences, how to calculate royalties, and what royalty rate to charge. Many commercial managers pick up this information as they go along, but there are some useful courses, such as the licensing courses run by PraxisUnico for the UK university sector.

Finally, it is important for the commercial manager to know their way around a typical licence agreement. Experienced licensing professionals see the same points being raised time and time again in negotiations, and there are usually standard arguments on each side of the negotiation. For some types of transaction, eg sale of goods, the commercial negotiations tend to focus on a few key issues, including specification, delivery, price and payment terms.

IP licence agreements have equivalent issues to these, but also have a larger number of secondary issues that are commercially important and cannot just be left to the lawyers to decide. For example, should the licensee be allowed to include a 'royalty stacking' clause that allows them to reduce the royalties paid to you if they also have to pay royalties to a third party? Should the licensor give warranties of non-infringement of third-party rights? Should the licensee lose their licence if they fail to bring products to market by a defined date? These are just a few examples of the types of issue that are typically negotiated in a detailed licence agreement.

Some issues that business managers face

When deciding whether to in-license or out-license IP, a business manager may need to address the following issues:

- *Why?* Will protection and/or management of IP be a good investment in support of my business strategy? Can I run my business without investing in IP?
- *What?* Have I thought through the pros and cons of investing in different types of IP (eg patents or trade marks)? Have I researched the IP landscape to see what IP my competitors have?
- *How?* Do I have the skills and resources (in-house or external) to protect and manage the IP and to negotiate IP licence agreements?
- *Costs.* Do I have a budget for legal and, if appropriate, IP filing fees? What will I do if a dispute arises under the licence agreement, or I face competition

from unlicensed competition? Will I have to take or defend legal action, or can I get my licensor or licensee to bear these costs?

Plan your deal terms before you negotiate

Finally, a heartfelt plea from an IP licensing lawyer: don't work out what deal terms you want in the middle of licensing negotiations. Establish in advance what terms you aspire to achieve, and your 'walk away' positions. This author has seen too many negotiations where deal positions are worked out 'on the hoof', in response to seeing how the other party reacts to commercial proposals. Leaving aside the question of whether this approach is likely to achieve the best deal, it can be very inefficient as a process and lead to an escalation of legal costs.

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As well as advising clients, Mark runs training courses on IP licensing and other commercial law subjects, and is the principal author of several textbooks on IP subjects, including *Technology Transfer* (3rd edn, Bloomsbury, 2010). He also runs a popular blog on the subject of IP contracts at www.ipdraughts.wordpress.com. Tel: +44 1865 858 878, e-mail: mark@andlaw.eu

Acquisitions

8.3

Acquisitions represent one of the most effective routes to growth, but how can you be sure that targets will realize their potential, asks Jessica Nugent at Goodman Derrick

For a business looking to grow, the acquisition of already established complementary businesses can be an effective method. Rather than having to develop a new division or department from scratch, a business can take on an already profitable undertaking, with employees, structures and business plans in place.

There are certain steps that can and should be taken to maximize the possible success and minimize the risks of such a strategy. A company, being a separate legal entity, will have its own liabilities and obligations and these may significantly impact on the value of the company. To avoid any unforeseen pitfalls, it is essential for a buyer to undertake due diligence investigations into the target company and to plan for its development as part of the buyer's existing business.

The following matters should be considered right at the outset:

- Most importantly, find the right business. Does the target fit in with the buyer's ethos, financial structure and long-term business plan so that it will complement the existing business?
- If the sellers are staying on, do the buyer and the sellers have the same vision for the business going forward and a common view of how the target will fit into the buyer's group? It is essential to discuss this early on to avoid pursuing an acquisition that is unlikely to go ahead or, worse, that does go ahead and quickly fails owing to conflicts of opinion.
- How will the company operate going forward? Will the target continue to operate as a standalone business, or will it be merged into the buyer's existing business? If the latter, what streamlining will this require in relation to financial resources, human resources, IT support and other functions? Any potential redundancies must be considered early to ensure that the liabilities of the buyer and the target are minimized.
- If the target business is operated by a company, should the buyer acquire the shares of the company or the business itself? This decision will often be tax driven and it is worth seeking advice early on. For the purposes of this chapter, we assume that the acquisition is a share purchase and not a business purchase.

Below, we look in more detail at particular aspects of an acquisition that a buyer can focus on to ensure the best prospects for its existing business and the target company going forward.

Employees

Employees are usually a key part of any business. Therefore, if a buyer wants the target business to continue to operate successfully, it will want to ensure that the target's key employees will stay on following the acquisition. In this respect it is worth checking the employment contracts carefully to see what notice periods and restrictions on post-employment activities apply to the staff. If they are on short notice periods and there are no restrictions to prevent employees competing with the business after they leave, the target is not well protected.

Another reason for checking employment contracts is to see what liabilities the buyer will be taking on. A buyer will want to be careful about taking on a business whose employees receive higher salaries, better benefits or more holiday entitlement than your existing employees; these entitlements cannot be withdrawn without the employees' consent and it may be that the buyer ends up having to increase the packages of its existing employees, at considerable cost to its existing business, to avoid having disgruntled members of staff going forward.

Considerable liabilities can arise if workers have been treated as self-employed consultants or freelancers when they are in fact employees by law. It is an employer's responsibility to deduct income tax and national insurance contributions at source; if it has not done so and the worker has not correctly accounted for their own tax through the self-assessment system, HM Revenue & Customs can claim any unpaid amounts, together with any employer's national insurance contributions that are due, from the employer. This can be a big expense and any potential liability should be taken into consideration when valuing the target.

Another area where the target may potentially bear significant liability is if it has not undertaken sufficient checks to make sure that all its members of staff have the right to work in the UK. There are considerable financial penalties for employing a person who does not have the right to work and there is also criminal liability if such a person is knowingly employed. Therefore, as part of a buyer's due diligence investigations, it should insist on having copies of the passports of all workers so it can assess which have the right to work by virtue of being EU nationals. Visas should be provided for any worker who is not an EU national.

Contracts

Depending on the nature of the target business, much of its value may lie in the contracts it has with its clients. If so, this is another area where detailed due diligence investigations should be undertaken. Firstly, are these contracts in writing? If not, how do the sellers propose to ensure that these clients stick with the business going forward?

If there is a written contract, check it for the following provisions in particular:

- Is there a change of control clause? When the buyer acquires the target company, there will be a change of control of that company. Many contracts will contain a provision whereby a change of control gives the other party a right to terminate the contract, or may even provide that a change of control causes automatic termination of the contract. To avoid a loss of important clients post-acquisition, it is advisable to get such clients to consent to the change of control before completion of the acquisition and to agree to be bound by the contract going forward.
- What is the notice provision in such contracts? If the client is able to terminate on short notice, it may again be worth gaining comfort that the clients will be happy with the new ownership. Also, if the target is being valued on the basis of its revenue, how secure is that revenue if the notice periods are particularly short?
- Are there any onerous provisions in any contract to which the target is bound? For example, long notice periods that tie the target in or terms that require the target to expend significant amounts in order to fulfil them. How will these affect the business going forward?

Intellectual property

In some cases, the target will have valuable IP rights, be it in trade marks, databases, copyright or know-how. In these instances, it is essential to ensure that the IP is actually owned by the target. Where the IP has been created or developed by employees, do their employment contracts provide that any IP created during their employment will belong to the employer? If the IP has been developed by self-employed freelancers or contractors, has there been an adequate assignment of the rights to the target?

If the target company does not own the IP, it risks liability to the owner if that IP is exploited without the correct licence. Therefore, it would be essential to establish what rights the target does have to use the IP. The value of the IP may fall in the exclusive right to use it, in which case if a licence is in place, does it guarantee that the IP may not be used by any other person?

It is also worth checking that any registered IP is in fact correctly registered. Are trade marks and domain names registered in the name of the company, or have they been registered in the name of a director or employee of the company? Transfers into the company's name should be completed prior to completion, or an undertaking should be obtained from the sellers to procure that the transfers will take place as soon as practicable.

Going forward

Having undertaken thorough due diligence investigations into the target company, a buyer should be very familiar with the target's business, its employees, its customers

and the way it operates. The buyer can use that knowledge to establish the best way for the target to complement its existing business going forward; will it integrate the acquired business fully into the existing business, or would the acquired business be better off continuing to operate as a discrete operation? This will very much vary on a case-by-case basis, but careful planning and consideration will help ensure the best possible success.

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