FRANDATA KEY FINDINGS AND SURVEY RESULTS:
2015 NATIONAL LABOR RELATIONS BOARD JOINT-EMPLOYER RULING

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Introduction

The National Labor Relations Board [NLRB] in August issued a ruling stating that franchisors and franchisees could be considered joint-employers of those working at franchisee-owned businesses. This ruling overturned decades of legal precedent pertaining to the franchise business model and the significant economic activity it supports.

MORE THAN 780,000 FRANCHISE BUSINESSES, OPERATING IN HUNDREDS OF INDUSTRIES, AND EMPLOYING MORE THAN 8.8 MILLION AMERICANS, USE FRANCHISING AS A BUSINESS MODEL.

FRANdata spoke with industry leaders and stakeholders, conducted secondary research, and examined company filings to assess the potential negative impact of the NLRB ruling on the industry and indirectly on the economy. While the final impact of the NLRB ruling, should it stand, remains to be seen, the views of these executives and franchise business owners were overwhelmingly negative.

Among the most significant findings based on our interviews and analysis are:

- An estimated 40,000 franchise businesses, affecting more than 75,000 locations, are at risk of failure because of the joint-employer ruling, which will increase labor and operating costs beyond operating margins.
- As a result of business failures, downsizing, and a decline in the rate of new franchise business formation, more than 600,000 jobs may be lost or not created.
- The equity value of franchise businesses is expected to drop by a third to a half. Rising costs will have a negative multiplier effect on valuations. Potentially, hundreds of thousands of franchise business owners will see the equity they have built in their businesses over years decline as the advantages of the franchise model are stripped away, causing higher operating costs.
- Loss of the franchise business model's operating efficiencies, combined with rising costs, will render the investment in a franchise business less attractive to entrepreneurs seeking to start new businesses.
- The combination of negative valuations, a decrease in the rate of investment in new franchise businesses, an increase in the rate of franchise business failures, and a lower rate of job creation in the franchising industry will have an overall negative impact on U.S. GDP contributions.

Socio-economic Implications

- At least 33,000 first-time, single-unit franchisees and 40,000 businesses operating in 75,000 franchise locations are at risk of failure because of the NLRB ruling and its resulting egregiously high labor and operating costs.
  - Typical labor costs for franchise business range between 20 percent and 40 percent.[1] Operating efficiencies from marketing, purchasing, training, and other support services provided by franchisors may be lost due to a joint-employer ruling, increasing operating costs and shrinking margins.
  - Unit-level operating margins typically run between five percent and 20 percent.[2]
  - An increase in labor and other operating expenses and a decrease in support services previously provided by franchisors will have a negative impact on unit level economics by an estimated five percent to 15 percent of gross revenue – wiping out an exorbitant portion of expected profits.[3]
  - Franchise owners will have limited options in the short-term for rising costs due to the impact of a joint-employer ruling. Those options include (a) passing costs on to consumers, (b) reducing products/services, and (c) reducing or eliminating jobs.
  - Many franchise owners in the long-term may choose to sell or restructure their businesses, or to postpone investment in new franchise businesses until there is greater certainty about a joint-employer ruling.
  - Many franchise owners have collateralized 401ks, other retirement savings, and their homes to guarantee loans taken to open their businesses; therefore, declining valuations and the risk of business failures pose significant risks to their personal finances and the security of their families.

- As a result of business failures, downsizing, and a decline in the rate of new franchise business formation, more than 600,000 jobs may exit the market or not be created.
  - Franchises added 500,000 jobs from 2013 through 2014, or about nine percent of all non-farm jobs. Assuming the rate of new job creation is reduced by half – fewer jobs added by existing businesses and fewer jobs created by fewer new businesses – the net reduction is 250,000 new jobs over a two-year period.[4]
  - 75,000 locations are at risk of failure over a two-year period. Average franchise employee count is 11, totaling 825,000 jobs. Even assuming half find jobs elsewhere, that would still leave over 412,000 jobs extinct.[5]

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[1] FRANdata database and internal analysis.
[2] Ibid.
[3] Based on 2015 Joint-Employer Impact Study Survey conducted by FRANdata.
[4] Franchise Business Economic Outlook for 2015, June Forecast Update. IHS Economics, prepared for International Franchise Association Educational Foundation. June 2015.
[5] Ibid.

- An estimated 20 percent of franchise locations are owned by minorities and at greater risk of failure.[6]
  - Over the past five years, minorities have increasingly found the capital to start franchised small businesses.
  - Many of these franchisees are highly leveraged and conducting business on thinner operating margins.

- More than 37,500 veterans could have employment opportunities eliminated over the next two years and 2,500 may be denied the opportunity to own a franchised business.
  - More than 200,000 servicemen and servicewomen return to civilian life annually, including many from service in Afghanistan and Iraq. Since 2011, as part of Operation Enduring Opportunity, more than 150,000 veterans have found careers in the franchising industry, including more than 5,000 who have become franchise business owners.[7]
  - Returning veterans typically have had less opportunity to build credit and acquire personal wealth/equity, making them a higher risk group to finance.
  - The very successful VetFran program, conducted through the IFA, has mitigated veterans' financing challenges by partnering with franchise brands willing to lower fees for the demographic. Even these substantial discounts would not offset the 5 percent to 15 percent increase in operating expenses stemming from a joint-employer overlay.
  - This assumes that 250,000 jobs lost over a two year period affect veterans proportionally.

Threats to Sustainability

- Business owners will lose a significant portion of the value of their business that they've invested in over time.
  - Franchises average 5 percent to 20 percent in operating margin. The increase in labor cost and the new need to find support at a much higher costs are likely to add another 5 percent to 15 percent to operational expenses at a unit level. This will put a significant percentage of small businesses' profitability and survivability at risk.

[6] 2007 U.S. Census Bureau survey of business owners.
[7] 2014 Veterans in Franchising, A Progress Report. Franchise Business Review, prepared for the International Franchise Association. 2014.

  - The equity value of franchise businesses is expected to drop by as much as a third to a half, since most franchised units' values are based on multiples of free cash flow, and significantly rising costs will have a negative multiplier impact on valuations.[8]
  - Legal and other administrative expenses associated with employment law and hiring, DOL standards, union negotiations, ACA compliance and the like will erode the operating margins of franchise small businesses.
  - As small business franchisees lose control over hiring, they will be burdened with the consequences of union contracts constraining a key element of the small business advantage: fast adjustment to ever-changing market conditions. Franchisees are already afraid to expand.[9]
  - Franchising will be less attractive to entrepreneurs due to the operating obstacles and significantly higher costs created by the ruling.

- The increased expenses incurred by franchisees will be passed on to consumers or absorbed by small business, putting their profitability, and in many cases survivability, in a precarious position. Passing costs to consumers affects the business' ability to remain competitive.

Support to Franchisees

- Less support by franchisors results in higher cost of doing business for franchisees, less operating efficiency and lower operating margins.
  - Franchisors are searching for ways to avoid being perceived as a joint-employer, translating into more expensive, less effective and efficient support programs.
  - Support and training on key functions, such as sales, marketing, technology, customer service, recruitment, business advice, will diminish or become more costly.
  - Many franchisees are not equipped to train outside sales reps, conduct effective marketing, or operate continually updated POS systems.
  - Franchisees can expect additional costs to train field operations staff to legally protect themselves during site visits.
  - Field support staff are being counseled by franchisors to anticipate new restrictions and reduce the amount of business and operational advice that has been part of the historical franchisor/franchisee relationship.

[8] Based on 2015 Joint-Employer Impact Study Survey conducted by FRANdata.
[9] Based on 2015 Joint-Employer Impact Study Survey conducted by FRANdata.

   - › Franchisors are offering less guidance under fear of legal implications; this undermines the fundamental tenant of the franchise business model: to support small business development.
- – Franchisee operational costs could rise from 5 percent to 15 percent annually in part as a result of the loss of franchisor support.

Expense to Franchisors

- – Five out of six franchisors are small- to medium-sized companies. Many of these companies will be forced to re-structure their business and to reduce or eliminate franchise development activity, training, and support to existing franchisees as they make adjustments to assume the resulting rise in legal and compliance costs of joint-employer.
- – Many franchisors anticipate increased costs due to legal fees, insurance and liability issues, re-structuring franchise agreements and field operations for compliance with joint-employer standards.
   - › Franchisors now average $30,000 to $60,000 in attorney fees for 80 to 120 hours per case to review the entire operations manual, evaluate franchisee and employee support, and alter other aspects of the business relationship under the stricter definition. Brands anticipate that nearly everyone with an employer agreement will try to associate the franchisor as a joint-employer, and they expect the number of such cases to increase by 100 percent in the coming year.[10]

Lending

- – Small Business Administration-guaranteed lending satisfies 21 percent of all capital required by franchisees each year.[11]
   - › If franchisors are deemed joint-employers with the franchisor, this source of funding may need to be replaced by much more costly alternatives with high interest rates that drain cash from a growing business, increasing the likelihood of business failure.
   - › Franchisees are becoming hesitant to inject capital into their businesses, lowering efficiency, increasing costs, and deterring both business and job growth. Some will not be able to obtain financing, or will opt not to at high cost.

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[10] Based on 2015 Joint-Employer Impact Study Survey conducted by FRANdata.
[11] Small Business Lending Matrix and Analysis, The Impact of the Credit Crisis on the Franchise Sector. Volume VII. June 2015.

Source Notes

FRANdata conducted a comprehensive examination of decades of regulatory findings for more than 2,900 franchise brands. This analysis was supplemented with industry white papers, government data and recent telephone surveys. Survey participants collectively represent over 300 franchisors, more than 15,000 franchised businesses, and over 6,700 lenders. Lending information was retrieved from SBA-published data for more than 1.1 million SBA guaranteed loans over the 15-year period from 2000 to 2015.

About FRANdata

FRANdata is the leading independent research and advisory company that focuses solely on tracking and analyzing franchise companies and their performance. Leveraging the largest database of franchise information in the world, FRANdata's comprehensive and in-depth analysis of franchise business operations supports the lending community, franchise small business owners, franchisors, suppliers, educational institutions, and government agencies. FRANdata is often cited as an expert in such leading media as The New York Times, The Wall Street Journal, and Forbes. Additional information is available on the company's website, www.frandata.com