FINANCIAL PERFORMANCE REPRESENTATION

MARKET DEMAND PUSHING HIGHER LEVELS OF TRANSPARENCY

A special report prepared by FRANdata for the IFA
Franchise Education and Research Foundation
April, 2017

ANYA NOWAKOWSKI
SENIOR RESEARCH ANALYST
FRANDATA

Table of Contents

INTRODUCTION

The International Franchise Association (IFA) Educational Foundation partnered with FRANdata to identify trends in financial performance representations in the item 19 section of the Franchise Disclosure Documents. The major findings are supported by statistics derived from the analysis of FRANdata's proprietary database and the results of two online surveys.

FRANdata examined the FPRs of over 3,000 franchise brands as presented in FDDs between 2014 and 2016. FRANdata then analyzed a representative sample of 259 brands that disclose financial performance representation, to assess the quality of their item 19 disclosure. This sample is statistically representative of the universe of franchisors that disclosed an item 19. The sample size was derived based on a 95% level of confidence and 5% margin of error.

FRANdata conducted two online surveys, one of franchisees and one of lenders, to gather additional information and identify trends in the use of FPRs. The franchisee survey analysis is based on the responses of 130 franchisees that are representative of the overall franchise population based on industry distribution and maturity. The survey provided insights into how prospective franchisees use FPRs, and what is most important to helping them make investment decisions. The lender survey analysis is based on responses from 40 lenders who work in the franchise lending market.

When considering whether to open a business, entrepreneurs try to answer a few basic questions:

"How much will it cost to operate?"

"When can I expect to make a profit?"

"How much money can I make?"

Franchises have a unique opportunity to provide answers to these questions. Every franchisor operating in the United States is required to issue a Franchise Disclosure Document (FDD), which includes a series of items. Item 19 features a financial performance representation (FPR) of existing businesses. Not all franchisors supply the same kind of information in item 19 – the requirements the Federal Trade Commission (FTC) places on franchisors are limited. Companies and their lawyers often differ in deciding what is appropriate to share. The North American Securities Administrators Association (NASAA) is in the process of releasing their new guidelines, intended to provide more uniformity and clarification around what franchisors can disclose in their FPRs. Whatever the level of transparency, FPRs provided by franchisors help establish realistic expectations for prospective franchisees. Lenders also use FPRs to make credit decisions and structure loans.

This report examines the importance of financial performance representations to the two groups who ensure franchise systems grow: prospective franchisees and lenders. It also examines patterns of transparency in financial performance representations over time. Over time, franchisors have increasingly made data available in their item 19. The main consumers of this information are unequivocal in their view that clear FPRs are critical to decision-making. FRANdata found ties between increased transparency and strong system performance. This represents a chicken-and-egg dilemma: does disclosing more data in item 19 lead to better performance, or do better performers opt to disclose? Either way, one thing is clear: the better brands more often disclose information in item 19.

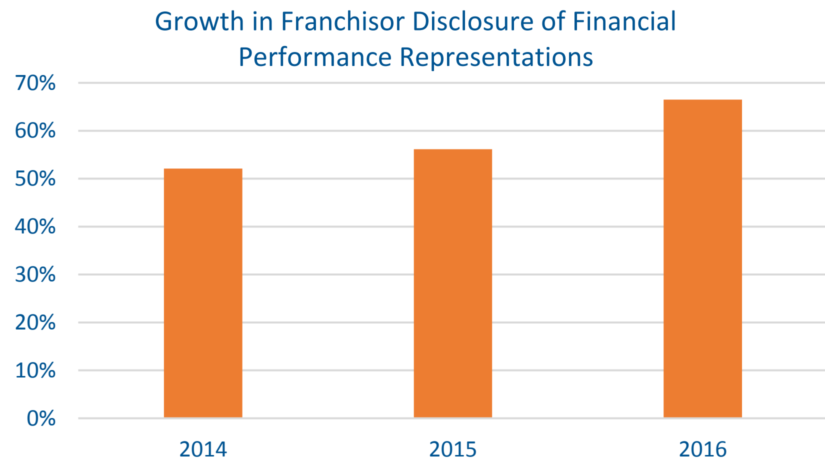
The Franchise Disclosure Document is a legal document. It is written by lawyers to specifications defined by the government so brands can operate in individual states. Historically, FPRs were omitted from Franchise Disclosure Documents or were very opaque. In part this has been for logistical reasons. Internal data collection and reporting, while increasingly common, is an ongoing challenge. Some brands have considered it a competitive disadvantage to publicize performance data. And ultimately lawyers, the authors of FDDs, were characteristically cautious in offering information that could expose their clients to litigation.

FRANdata finds that the franchise business model has been increasingly transparent, which has ultimately facilitated growth. Critically, it has not increased litigation. The latest trends are consistent with FTC rules, which encourage transparency but otherwise leave open the ability of franchisors to adjust the data they disclose so that it most accurately represents the varying characteristics of their system. By providing detailed FPRs in their item 19s, franchisors can stay in line with industry best practices, leverage a competitive advantage, and facilitate growth, all while controlling how their systems are represented.

EXECUTIVE SUMMARY

FRANdata examined over 3,000 franchise brands over the four-year period since 2012 to assess trends in franchisor disclosure of system financial performance representations, looking both at the rate of disclosure, as well as quality of the information provided.

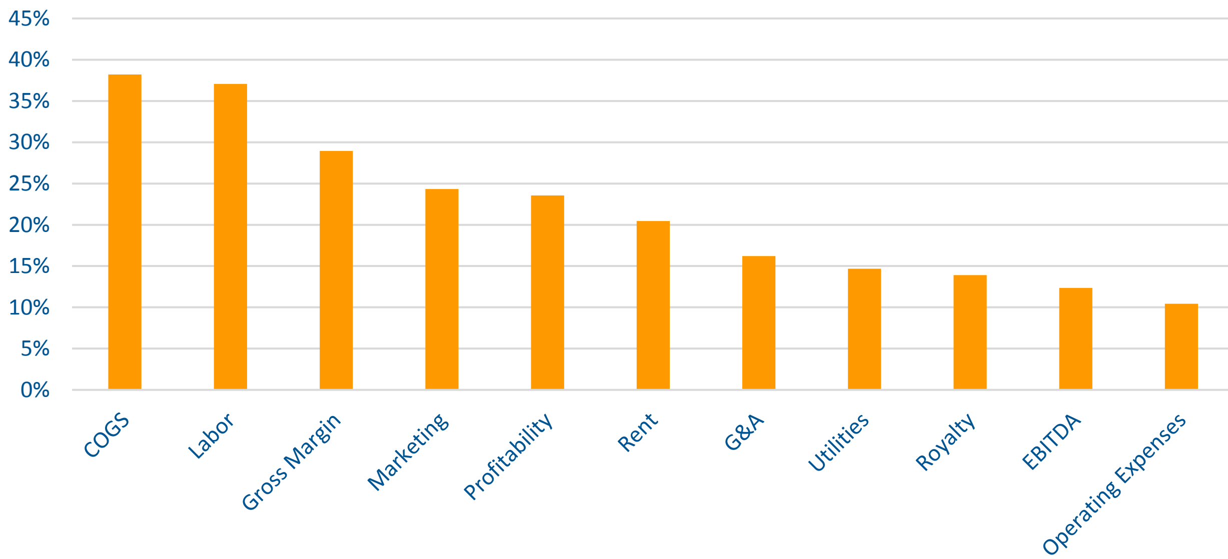
- Market demand has been driving franchisors to increase transparency into their system's financial performance and the percentage of franchisor disclosure has steadily increased since 2012.



- Brands that operate in more competitive spaces demand higher transparency into their system financial performance. The higher the brands' investment levels and capital requirements, the more likely franchisors within that investment range are to disclose their item 19.

- While the most basic and common disclosure is for top line sales – with 94% of franchisors with an item 19 disclosure providing average unit revenues – this tells only half of the story. The most important thing for a small business in the start-up phase is having adequate capital. Therefore, both prospective franchisees and lenders need to understand the businesses cash flow. Forty-seven percent (47%) of franchisors who provide an item 19 disclose any operating expenses, and 34% provide information about profitability, including operating income, earnings before income, taxes, depreciation, and amortization (EBITDA), gross profit, or net income.

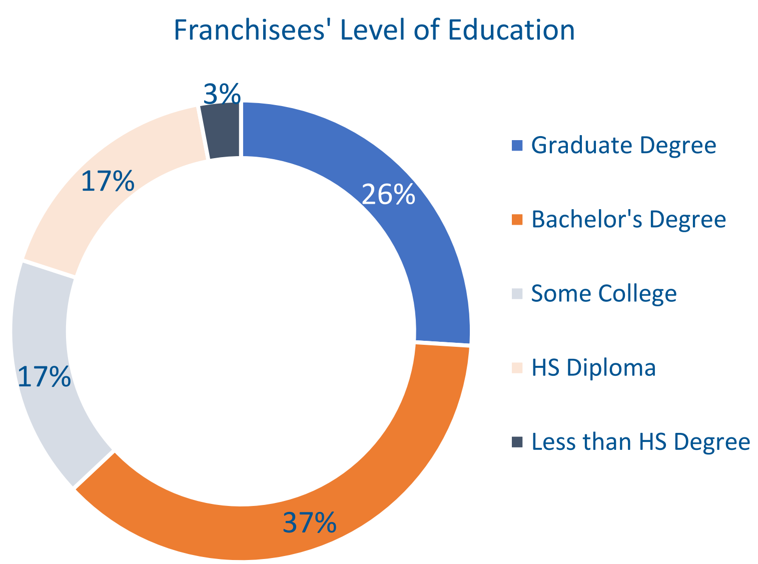
Expenses & Profitability Disclosure Rate



MARKET DEMAND DRIVES HIGHER TRANSPARENCY

Item 19 transparency overtime has increased – a growing number of franchisors have started disclosing their system's financial information. Franchisors have been making those strides in response to market demands – they know that to attract the best franchisees they need to illustrate the potential financial opportunity.

Franchisees are getting increasingly more sophisticated and are exposed to endless information about franchise brands in which to invest. Franchisees come from many backgrounds, but 78% have some business, financial, or accounting background, likely having been exposed to business operations and financial information prior to becoming a franchisee. Additionally, most franchisees today are highly educated – 63% have a Bachelor's or Graduate Degree. Overall, 73% of franchisees surveyed were confident in their ability to understand FPRs presented in an item 19 regardless of their background.

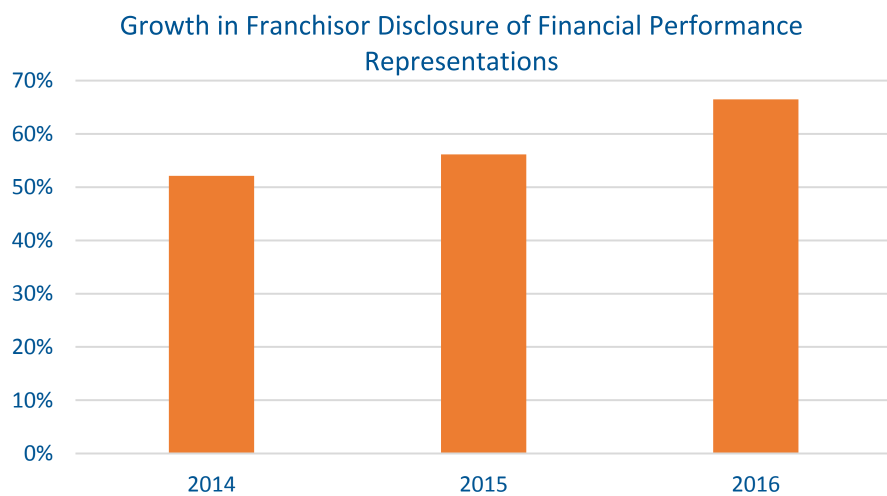


An average of 300 new brands start franchising each year, and while older systems are generally more likely to provide financial information, 40% of new brands are starting off on the right foot by collecting and disclosing financial information from the beginning. With this many new brands entering the already crowded market, franchisors are using FPRs to stand out to prospective franchisees.

Franchisees today are taking advantage of their access to resources and information to help them make an informed decision before investing in a franchise. Beyond reviewing the overall system financial performance information in the item 19, 52% of franchisees said they went a step further to verify the accuracy and get a better understanding of the individual factors affecting their earning potential. Franchisors often encourage prospective franchisees to speak to existing franchisees to verify the financial information and gain first hand insights into actual individual financial performance potentials and experiences. This is the most common source franchisees use to verify the accuracy of the reported financial information, used by 80% of franchisees. Franchisees also consult their own accounting professionals, business advisors, and independent consultants to gain insights into their potential performance based on the system's historical financial performance.

Multi-unit franchisees continue to develop new units and grow their portfolio strategically, already having the experience and performance history of running their existing franchises to compare and benchmark other investment prospects. Only 20% of franchisees are multi-unit operators who control 54% of all units in the market. These franchisees already know what to look for and know how much they want to grow their overall business portfolio. Without any information about the system's financial opportunity, these franchisees are more likely to invest in another franchise, one that provides more transparency.

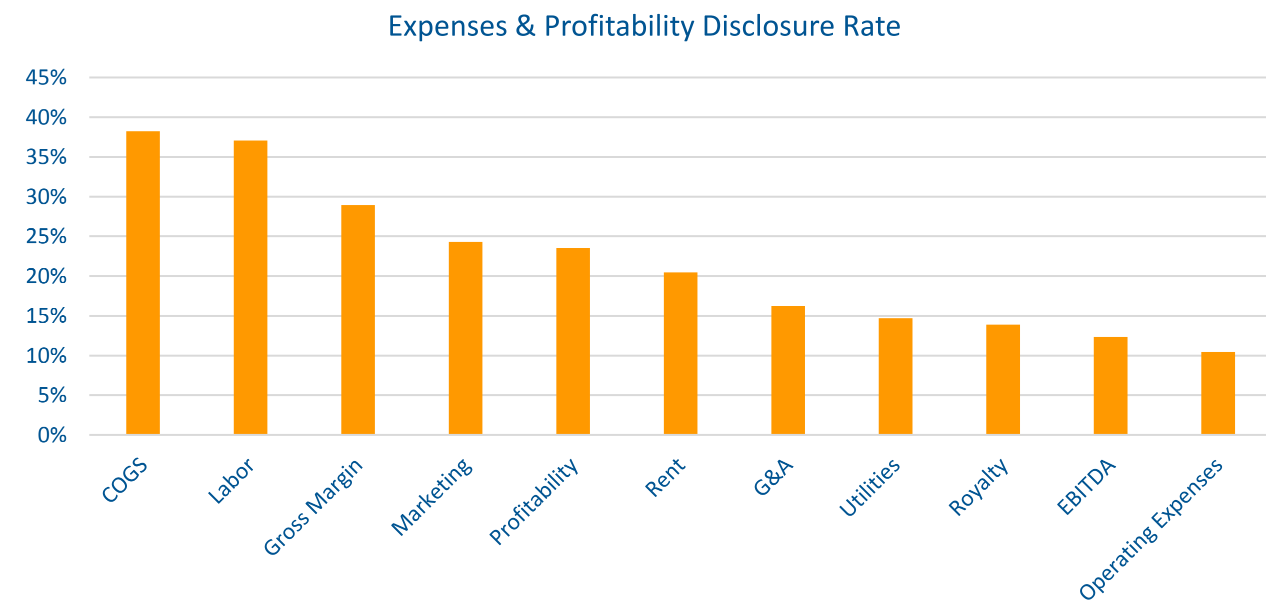
Recent years have seen a dramatic increase in franchise brands that disclose financial performance information in their item 19. Based on FRANdata's examination of more than 3,000 brands, two-thirds are now providing FPRs in their Franchise Disclosure Documents.



The most common detail that franchisors report is average unit revenues (AUVs), simply because these are the easiest for the franchisor to collect and present. Revenues are the basis for royalty and marketing fees that franchisor's collect from franchisees. Of all franchises that disclose something in an item 19, 94% of them disclose average unit revenues. The mere presence of AUVs can be of mixed utility, and the basis of the data is important. One best practice is to disclose data based on franchised units (rather than corporate units) that have been operating for a full year. The information presented in the item 19 must be representative of the system and have a reasonable basis, which must be specifically stated in the reporting. This still gives franchisors quite a bit of leeway as long as they detail what the information is based on. 86% of franchisors who disclose franchised AUVs report them based on an average of

77% of their total franchised system, with others disclosing based on corporate units or projected performance. Since 2014, almost half of franchisors have increased the basis of their reporting to include a larger portion of their franchised system.

Top line sales tell only part of the story. Understanding a business' operations and its associated expenses provide insight into the profit potential of a business, and equip the franchisee to make a viable business plan. Without profit and loss statements, an item 19 is incomplete from the perspective of a prospective franchisee. The most commonly disclosed expense items are cost of goods sold and labor costs, both of which are shared by around 38% of franchisors. Food brands are more likely to disclose expense information with 61% of food brands providing any expenses, mostly cost of goods sold, compared to 39% of service and nonfood brands.



The final and most important piece of the equation is profitability. Overall, 34% of franchisors report some indicator of the system's earning potential, including operating income, earning before income, taxes, depreciation, and amortization (EBITDA), gross profit, or net income. 44% of food brands opt to disclose gross margins compared to only 20% of nonfood or service brands.

FRANdata identified a subset of 36 brands that provide the highest quality and transparency in their disclosure based on both the number of financial metrics disclosed, weighted according to their value to prospective franchisees and lenders, as well as how representative the basis of the numbers were relative to the whole system. All brands in this set disclosed AUVs, profitability, and an average of 4.5 expense categories based on 88% of their franchised system. The most transparent brands grew at a rate of 14% between 2013 and 2015, with an average of 418 franchised units in operation in 2015. Brands with the highest quality disclosure also had 46% higher investment levels than the overall sample.

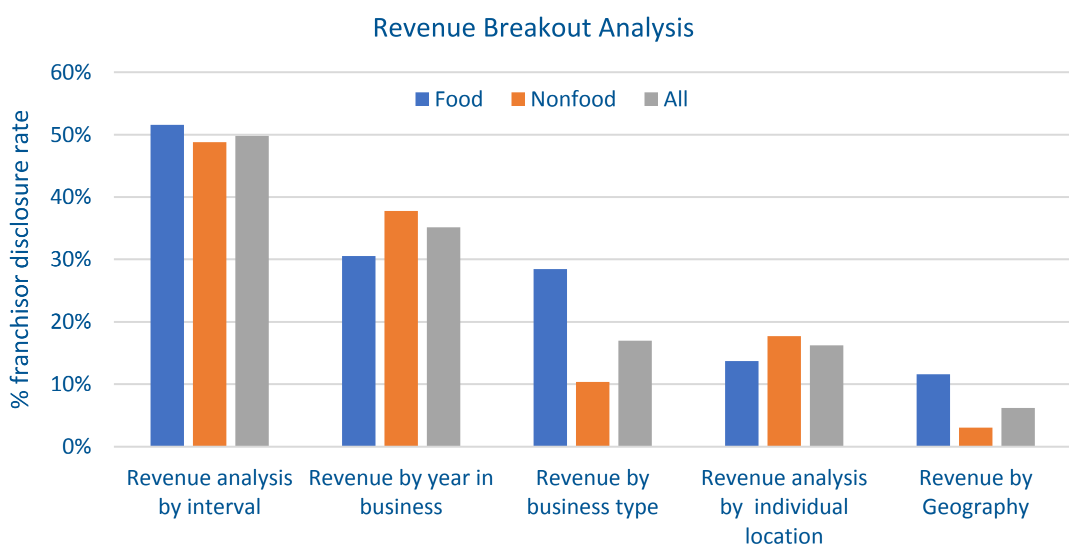
Accounting for Variance & Outliers

While AUVs are the most commonly reported financial metric in a franchise's item 19, many brands opt to go beyond that to attract better franchisees. Franchisees are becoming more sophisticated and the competition between franchisors for these potential business owners is increasing in intensity. Facing this competition, many better performing brands chose to go beyond the traditional AUV disclosures to attract the best franchisees to their systems.

Since financial performance varies based on many factors including the age of the business, geographic location, market characteristics, type of location, size, and the sophistication of the operator, a simple average may not accurately reflect the performance of the system. Franchisors often break down their system's performance based on any of the above characteristics, providing more visibility into how they can expect to perform based on the characteristics of the business they develop.

The most common way franchisors breakdown system revenues is by interval analysis, which is provided by 49.8% of franchisors who have an item 19 disclosure. This type of interval analysis includes a combination of revenue ranges and averages by quartile or other interval periods.

The level of activity for an emerging business can be very different to that of a mature one. To account for that variance, 35% of franchisors present revenue analysis by the number of years in business – franchisors of nonfood and service brands have a higher tendency to disclose this breakdown to set expectations reasonably and to help the franchisee prepare for this critical part of their growth.



One of the most important data points for both lenders and prospective franchisees, is the first 12 or 24 months of revenue, and the time it typically takes businesses to reach breakeven. The age and maturity of a business has different impacts on financial performance depending on the industry. For example, restaurant concepts experience what is known as the honeymoon period with exceptionally high revenues in their first few months in business, then slowing down and stabilizing. Whereas many services based and membership based concepts experience a longer ramp up period during which sales are low until they build their customer base.

The first few years of a business's operations can be make or break and franchisees need to be prepared financially. In 2014, only 3.5% of franchisors provided the first 12 or 24 months of revenues and less than 1% disclosed the time to breakeven. In just two years, this almost tripled to 9% of franchisors providing ramp up revenues in 2016, with 11.6% of nonfood and service brands compared to only 4.2% of food brands. An understanding of a business's stabilization period is extremely important when a new franchisee is setting up financing and their business plan.

Better Performing Brands Are More Transparent

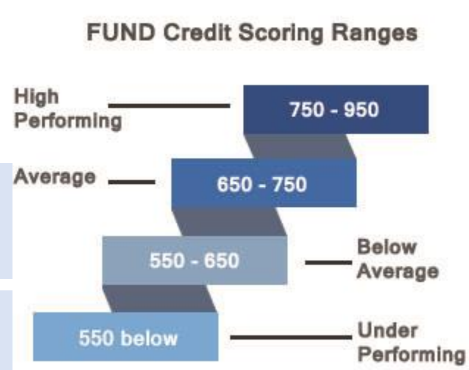
The trend towards increased levels of transparency in unit FPRs has largely been driven by better performing brands. Franchisors that disclose system financial information grew their franchised system by 15% compounded annually between 2013 and 2015, compared to 11% among brands that disclose no financial information.

In part this increased growth is a function of the faster opening times that transparent financials allow. In addition to granting franchisees more insight into the business they are about to open, making decision-making easier, detailed FPRs also facilitate capital access. Eighty-four percent of lenders said that having a system's financial performance information speeds up their loan underwriting process by 3.8 days on average. For the franchisor, this means that franchisees open their units over half a week sooner. On average, brands that disclose their financial performance representation open an average of 22.6 units each year; while brands that don't only open 13.1 units each year.

Transparency into a system's financial performance makes loans to its franchisees less risky because the lender can assess the viability of a borrower's business plan, and ultimately whether the franchisee can generate the cash flow to pay on debt. Brands that make financial performance representations score

Average FUND score for brands with an Item 19 is 585

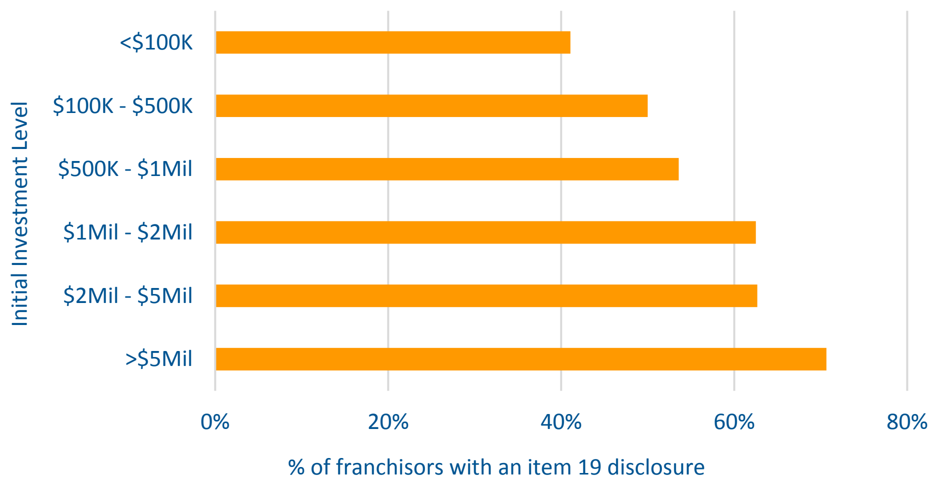
Average FUND score for brands with no Item 19 is 441



higher franchise credit (FUND) scores. On average, brands that disclose system financial performance scored 33% higher from a credit risk standpoint, than those with no transparency into financial performance.

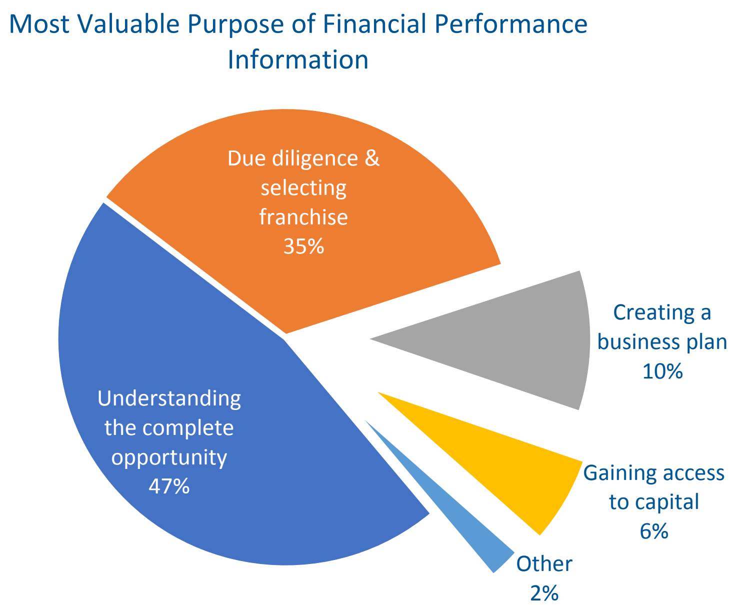
Brands with higher investment levels are more likely to provide financial performance information to prospective franchisees. Brands with an item 19 disclosure have average initial investments of $1.6 million, compared to brands with no disclosure that had an average $1.1 million initial investment. Brands with higher capital requirements are competing for a limited pool of qualified franchisees that have the financial means to invest in the business. In fact, the higher the investment level, the more likely a franchisor is to disclose FPRs – 41% of brands with investment less than $100,000 disclosed item 19, compared to 71% of brands that require an investment greater than $5 million. Franchisees considering brands with high investments need more information and assurance that they will get high returns on their investment. The lodging industry has the highest disclosure rate among all industries in franchising because of its high investment levels.

Higher Investment Levels & Higher Disclosure Rate



FRANCHISEE PERSPECTIVE

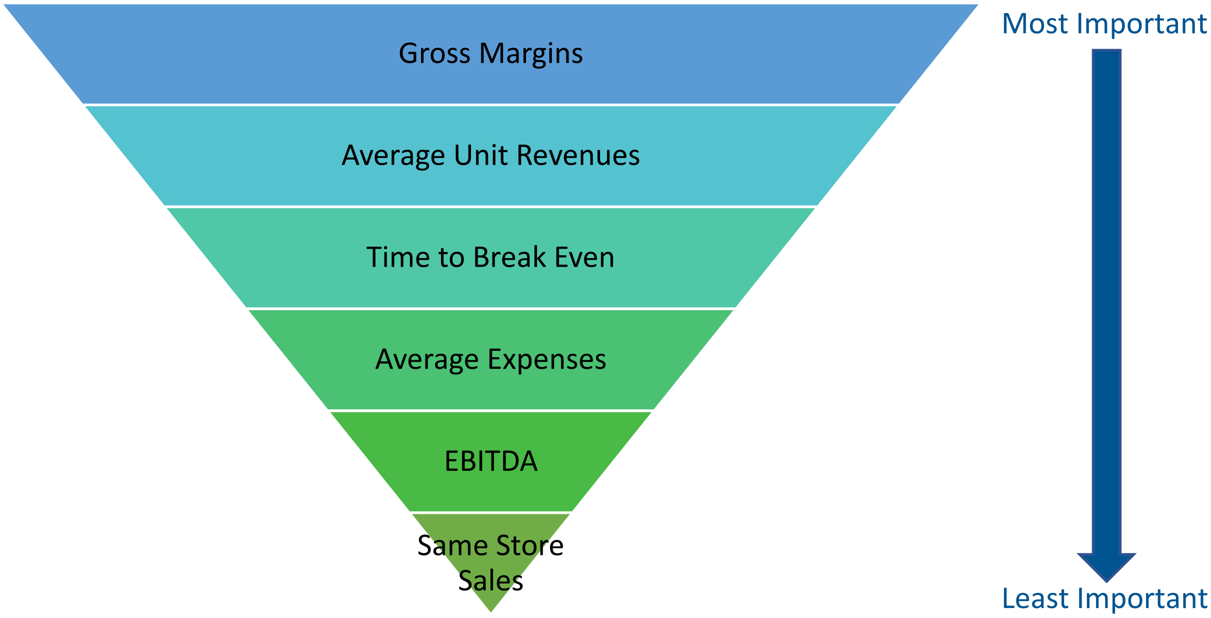
The primary intention of FPRs is to equip prospective franchisees to make an informed decision when investing in a franchise. Based on our survey, prospective franchisees considered three brands before ultimately selecting one. The most important factor was a brand's unit financial performance, which they ranked higher than the initial investment levels, fee structure, and the franchisor's support system.



Franchisees rely on FPRs as an early step in making their decision – 47% of franchisees consider the item 19 information most valuable to helping them understand the complete opportunity, while another 35% said it helped most with their due diligence.

When evaluating a brands' financial potential, prospective franchisees ranked gross margins as the most important financial metric followed by average unit revenues. Understanding a system's average gross margins helps prospective franchisees estimate their earning potential and develop an accurate business plan. Prospective franchisees can apply gross margins to any level of revenues they anticipate generating in their first few years. While AUVs are the most common data point available, they are insufficient for franchisees to build business plans and make investment decisions.

Most Important Financial Metrics Ranked by Franchisees



Time to break even is also important for prospective franchisees starting a new business, as it indicates what the ramp up period will look like and when they can expect the business to be profitable. From a business planning perspective, the time to break even helps franchisees estimate how much working capital they will need going into the business.

LENDER PERSPECTIVE

FPRs help franchisees make informed investment decisions, but once they invest in a franchise, it also helps them get financing faster and on better terms. While the primary audience of the item 19 is the prospective franchisee, lenders benefits from FPRs to determine whether to commit to financing and if so, on what terms.

While other mechanisms exist to get such information to lenders (franchisor-developed lender packages, bank credit reports, etc.), the easiest way for a franchisor to control the information that drives lending decisions is a detailed item 19. Unlike with franchisees, franchisors are not restricted by the FTC rule when providing information to lenders, so the item 19 is not the only solution for franchisors to provide lenders with information to help their franchisees get access to capital on the best terms. While these other options are important, they require the franchisor to get ahead of the lender, who often looks first to the FDD.

Whether lenders have FPRs, franchisor-provided performance summaries, or Bank Credit Reports, the important point is that they need this information to make good credit decisions and establish loan terms. When underwriting a first-time franchisee borrower, 97% of lenders say they are more likely to make a loan deal for a brand that provides details in an item 19. Many lenders won't even consider a loan for a brand with no such public or third party validated information.

Good underwriting analysis incorporates a combination of the borrower's and the brands' credit risk to understand the viability of the business and the likelihood that lenders will get their money back. All lenders weight the balance of the two differently. Some weight a brand's performance by as much as 70%, while others only weight the brands' performance by as little as 15% of their overall credit decision. On average, lenders weight brands performance by 40%, with the borrower's financial position influencing the remainder of their credit decisions.

From a lender's perspective, while it is good to know average revenues, the bottom line is most important when determining the likelihood they will get their money back. 51% of lenders said EBITDA is the most important element of a systems' financial performance when they are underwriting a loan for a first-time franchisee.

CONCLUSION

Franchisors have been increasing transparency into financial performance representations of their systems, mostly driven by market demand and competition. Lenders and franchisees alike want to see a system's profit potential before investing in or lending to a specific brand. The depth and comprehensiveness of those disclosures cover the entire spectrum – from no disclosure, to detailed and sophisticated breakdowns and analysis helping franchisees more accurately estimate their earning potential. Overall, brands that operate in more competitive spaces demand more transparency into system financial performance, including those with higher investment levels.

Brands that are transparent into their system's financial performance are overall better performing systems. Prospective franchisees are increasingly aware of this point. Brands with substantive FPRs have a higher franchised system growth rates, open more units each year, and, from a lending standpoint, represent lower credit risk. It's difficult to say whether financial transparency drives better performance or vice versa, but it's clear that transparency into a system's financial performance drives better franchise development strategies, attracting better franchisees, helping them establish more realistic business plans, and getting them access to financing faster and on better terms.

For more than 25 years, FRANdata has been the industry leader in the strategic analysis, forecasting and measuring of franchise performance and operations. Leveraging the largest database of franchise information in the industry, FRANdata helps any business that touches franchising by providing the objective information and analytical expertise they need to make smarter and better business decisions. FRANdata, headquartered in Arlington, Va., is often cited as a franchise expert in such leading media as The New York Times, The Wall Street Journal, Forbes Magazine and The Washington Post.

Powered by the FRANdata database, the Franchise Registry provides every franchisor the opportunity to make financing easier and better for their franchisees. Thousands of SBA and conventional lenders visit the site every month to find and learn about the franchise brands to whom they are considering lending. Besides publicly validating that a franchise is viable and thriving, the site allows franchisors to take advantage of such financing tools as SBA financing tools, Bank Credit Reports, Enhanced SBA Loan Performance Analysis, and the FUND report helping lenders understand and underwrite the franchise brand.

1.800.485.9570 I www.frandata.com I www.franchiseregistry.com