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## Get big or get out

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In the last 18 months, the sector has seen a string of mergers and acquisitions led by the sector's biggest groups, including Retail Food Group (RFG), Franchised Food Company (FFCo), Allied Brands and Jim's Group.
There are number of factors behind the takeover trend. Organic growth through franchisee recruitment remains difficult, margins in retail-related franchise systems remain tight and some smaller operators are looking to get out.
But there is one big theme underlying this consolidation push – Australia simply has too many franchises.
The most recent protagonists in the great franchise buy-up are services franchise giant Jim's Group and retail food franchisor FFCo.
In late June, Jim's Group founder Jim Penman announced he had started targeting medium-sized trades businesses (such as plumbers and electricians) with the idea of "rebranding" their businesses under the Jim's umbrella.
In May, FFCO acquired Nutshack, an Australian retailer of nuts, confectionery and dried fruits for an undisclosed price. Last year the company bought the Cold Rock chain of ice-cream stores to add to the Mr Whippy and Pretzel World brands and the latest acquisition of Nutshack pushes total store numbers for the group to 135.
Retail Food Group (RFG) has been similarly active in the last 18 months, completing the acquisition of Big Dad's Pies in April, and the acquisition of the DCM (Donuts, Coffee, Muffins) in January. These businesses were added to the company's stable of brands, which includes the Donut King, Michel's Patisserie, Brumby's Bakeries and bb's cafe franchise systems.
Other companies to have made takeovers in the past 18 months include Allied Brands, which acquired the small Coffee Bean and Tea Leaf chain in January and Villa & Hut in June last year, and Boost Juice, which bought 32% of Mexican food chain Salsa's in May after founders Janine and Jeff Allis sold a 70% stake in their business to an American private equity firm,

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The Riverside Company, for between $65-70 million.What's driving consolidation?
What is driving many of these deals is a need get a franchise system to a point where it is sustainably profitable.
Franchising experts say there's no exact number of franchises you need to reach this point, but many businesses find it hard to grow past about 25 or 30 stores.
It's something that Nicola Mills, chief executive of franchise brand manager Pacific Retail Management, which runs Go Sushi, Kick Juice Bars, Love Coffee & Crepes and Beard Papa, sees a lot.
"You'll see a lot of franchisors, they'll get really fast growth, then they get to that kind of 20 to 30 stores and it just seems that everybody stops," she told SmartCompany earlier this year.
"Having 50 stores or more means that the franchisor can turn a profit; having 25 stores or less means you're not... if you're a good franchisor. And being a good franchisor means that you are actually supporting the franchisees and doing the right thing."
"You can make money out of having 25 stores or less but that means you're taking all the money out of the business and not reinvesting in it. So franchisors need to have 40 or 50 to actually start being profitable themselves."
Michael Sherlock, FFCo chairman and former Brumby's CEO, agrees.
"In my experience when you start off you have an owner with a concept and a plan and you do everything, but as you get bigger you have to start employing people," he says.
"Once you get to 30 franchises you need all the specialty departments like purchasing, training, IT, research and development, marketing, etc. In order to be of full service to your system you need these systems in place," he says.
"Until you have critical mass and enough turnover or capital to invest, it's hard to get to that next level. You can get up to 20 or 25 and then you hit the wall a bit," he says.Organic growth dries up
Obviously, the best way to get over this hump is to recruit successfully. But this isn't always easy.
The GFC was supposed to be the time when potential franchisee numbers

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would climb in line with redundancies, but unemployment never really rose and recruitment never got any easier.
A recent survey by LINK Business Brokers of 2500 clients found that only 28% of people were interested in purchasing franchises, and franchising expert and SmartCompany blogger Jason Gehrke says the situation is unlikely to improve in the short-term.
"Banks have tightened lending criteria and there's uncertainty in the market, people who have got jobs are more inclined to hang onto them than take the leap into the great unknown of small business," he says.
"Particularly when rates are rising and the global financial crisis doesn't appear to be over."
Chris Acret, long time franchisor and managing director and founder of Smartline Mortgage Brokers says recruiting remains one of the hardest aspects of franchising. Smartline now has more than 200 franchisees, but most of the recent growth came from a merger with West Australian company Mortgage Force.
"I've been in franchises at Smartline and Mortgage Choice for over 15 years and recruiting is always a challenge, and in the last five years, particularly in Australia, finding people is harder," he says.
"The last few years have been difficult. When times are uncertain people are less inclined to move and are more likely to stay where they are."Smaller players suffer from over-franchising
Smaller franchise systems, with less brand awareness, less capital to invest in recruiting and less established systems, struggle even more, says Rod Young of franchise DC Strategy.
"The majority of franchises in Australia are quite small and it's their value to prospective buyers that stunts their growth."
"I would say that over 70% of franchise systems have less than 25 units in Australia. Over 50% have less than 10 units and as a result are simply not that viable," says Young.
"These smaller franchise systems don't have a competitive offer to the market place. A 10 store franchise cannot make any decent money so they tend to become dormant and don't grow. In Australia, 150 franchise systems have over 70% of Australia's franchisees in them. The bigger brands are dominating."

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Young also makes the point that too many business enter the world of franchising because they can, rather than because they should.
"One of my great criticisms of franchising in Australia is that there are too many companies selling franchises and not enough companies creating franchises and there's a world of difference between the two."
"If a franchisee doesn't prove it's profitable then the franchise model isn't validated and people won't be interested."
"Anyone can sell one, two or three franchises but after that people start to realise it's not making any money and that's the reason that the majority are under 10 stores. They cannot represent a profitable business model."
Young says the glut of smaller franchises means the Australian sector is effectively oversupplied.
"In the US there are 35,000 franchises in a population of 300 million. In Australia there are over 1,000 systems in a country with a population of 20 million. So you can see that we're heavily over franchised."
"The shopper or potential franchise has a choice of 1,000 systems and is gravitating towards the more proven and profitable businesses like Brumbys, Bakery café, Hairhouse Warehouse and Boost Juice," says Young.
The recruitment drought is forcing some franchises to give significant discounts on franchisee fees, enticing incentives or even give franchises away for free in order to get recruits.
But this is a bad move for both parties, warns Young.
"I like to call it 'Young's first law of franchising. Every franchisor gets the franchisor he deserves."
"No amount of advertising or enticement will bring a reasonable applicant to the table. If this happens, franchises get sold to a wood duck and if that wood duck is a poor quality franchise owner, they will not be successful."More consolidation likely
With recruitment conditions unlikely to improve, industry consolidation is certain to continue.
FFCo's Michael Sherlock believes smaller franchisors have to realise the merits of selling out to a bigger player.
"I think consolidation is a natural thing. As a franchisor you have to plan for a growth phase and understand that when you reach a certain stage you

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may not be able to offer the support to your franchises. If you can't expand, you need to be looking at mergers and creating economies of scale," says Sherlock.
"Acquisition makes sense from our point of view. In order to provide the level of support to our franchises that we need to, it can be very expensive but now with 135 stores we have some good critical mass. To support your franchisees it's important to co-brand wherever possible."
The executive director of the Franchise Council of Australia, Steve Wright, welcomes the trend.
"Franchising has become more attractive to investors who are not necessarily your traditional organically growing franchises," Wright says.
"It's definitely a healthy thing for the industry because what you want to see is reinvestment in successful brands. Where you can get capital backing for successful people and ideas it's good for the sector. It will definitely continue."Small and profitable franchises will be snapped up first
Rod Young points out that the bigger franchises and brand management companies aren't just buying any small franchises – they are going for the ones that have strong business models but are still relatively easy to bolt-on to an existing chain or business.
"We can see this sort of survival of the fittest," says Young.
"The good emerging franchise systems are actually being wooed by what we describe as the 100 leading franchises in Australia.
"Smaller networks that are not emerging and aren't that profitable are being left as the bridesmaids in this rush to mate. They're the ugly ducklings in this franchise scenario and unfortunately aren't even cute," he says.
"The bigger ones will continue to take over small systems because it will be fairly rare for two small networks to get together because neither offers the other much value and neither has much money."
Of course, there is one danger with mergers and acquisitions – the integration of two businesses does not always go to plan.
This problem was underlined recently by Allied Brands, which just last week released a shock profit warning and slashed $32 million of the value of some of its brands, including Villa & Hut, Awesome Water and Awesome Entertainment.
But Smartline's Chris Acret, who remains on the lookout for further deals,

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says it's a risk than needs to be managed.
"It's getting that cultural fit and business fit that's difficult and it's harder said than done. But there will definitely be ongoing consolidation in our industry... as bigger businesses buy out the little ones."

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