Case studies

Shift and Pivot or Stay the Course? An Emerging/Re-emerging Franchise Strategy

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A small pizza franchise is struggling financially and the owners are discussing new ideas and strategies for growing and improving the business. What should the owners do to ensure the success of the business?

Case Synopsis

This case follows two seasoned entrepreneurs who partnered to create a pizza franchise that is not flourishing as expected. With the proposal of a radical new idea which will change the scope of their franchise and their backs against the ropes, the question is what should they do now?

Teaching Objectives

- Describe the opportunities and challenges that emerging franchise systems encounter
- Analyze the initial investments of different franchise offerings and how to choose the best fit
- Identify how emerging franchisors could change their strategy when expectations do not meet reality

Situation

George looked up after finishing his breakfast and realized Ralph had barely eaten his. He then realized this wasn't the typical Saturday business breakfast at his favorite diner…

"What are we going to do?" Ralph proclaimed.

"What do you mean?" George replied.

"We've only managed to sell six franchises, where are we going to find more franchisees? These larger pizza chains are hard to beat," Ralph responsed.

"Let me tell you something Ralph, let me tell you something. Don't worry about it. I got it!" George confidently exclaimed.

"Got what, what is it?" Ralph questioned.

George merely smiled and responded with "*Pizza Vending Machines.*"

"What does that even mean?" Ralph further questioned.

"It means a 12-inch personal pizza baked fresh in under three minutes!" George proclaimed.

New Franchisors Seeking Franchisees

George, who was in his early 50s, had spent the last 25 years of his life selling used cars. He began by selling cars out of his home's driveway and eventually built a small used car dealership which he recently sold for one million dollars.

Ralph, who was the same age as George, had spent the last 5 years owning and operating his own liquor store business wherein he sold pizza by the slice. For many years George would meet with Ralph once a week for breakfast at their local diner. But, now that George sold his business and had more free time and money, he was visiting Ralph numerous times a week at his store and indulging in Ralph's pizza by the slice. Every time they met Ralph repeated the same thing, "I am sick of the liquor store business but I love making pizza."

Being not only his best friend but also an avid customer of Ralph's pizza, George suggested Ralph sell his liquor store business and that they partner in opening a pizzeria that they will franchise with the hopes of being able to retire in comfortably in a decade or so. And, that is exactly what Ralph did. He sold his liquor store and netted $100,000.

George and Ralph found a small commercial building that they purchased retrofitted and gave birth to "Good Pizza". They tried to do as much of the work themselves to lower the cost but still ended up spending $300,000 between the two of them ($200,000 for the building and $100,000 for the buildout). In essence, they both invested $150,000 of their own money.

After one year in business, Ralph and George became profitable and decided to franchise their business. They spent another $50,000 on attorneys and fees to do so. Raising each of their investment to $175,000 in total ($350,000 combined).

As luck would have it, a friend of theirs named Odie wanted to invest in their franchise concept. He negotiated to become a franchisee and build three stores if they would waive their franchising fee which was $15,000 for a 10-year commitment. His rationale was that more locations would be perceived as a success and that it would be easier for George and Ralph to sell more units and raise their franchise fee. They agreed to Odie's proposal with the caveat that he fund his own local advertising for his three stores,

Franchise Systems Stores	Open Stores	Stores in Progress
Corporate owned stores	1	0
Franchisee #1 (Odie)	2	1
Franchisee #2 (Luis)	2	0

Estimated Initial Investment – Good Pizza Store

Initial Franchise Fee	$15,000
Initial Investment	$100,000 - $300,000
Net Worth Requirement	$50,000
Cash Requirement	$30,000
Franchisor Royalty Fee	6%
Local Advertising Royalty Fee	4%
Term of Agreement	10 years

which would be on the other side of their state and still pay the 6% royalty fee on gross sales. Within the next year their first franchisee had two stores up and another in the works. During this period, they marketed and advertised their franchise and even used brokers to find more franchisees. Through their efforts, one additional individual named Luis joined their franchise system and agreed to open two stores. He paid a $25,000 franchise fee for both stores which was a $5,000 discount since each store originally had a $15,000 franchisee fee. His agreement also included a 10-year commitment and the 6% royalty on gross sales.

Within a few months, their second franchisee had both stores up and running bringing their system to a total of five locations with one still in the works.

Then, the unexpected occurred.........

A Global Pandemic!

The pandemic caused the government in their state of operation to suspend all indoor and takeout dining for public health and safety reasons for around six months. After a six-month closure all of their stores they had a booming year and a half which helped each store survive. Eventually the boom ended and sales subsided to pre-pandemic levels allowing each store to still remain profitable.

Current Situation

Fast forward to today, three years after the start of the pandemic, and Odie managed to finally open his third store making it a total of six stores for the Good Pizza franchise system.

While the chart above may show the beginning of the successful franchise system, Good Pizza has not been able to acquire another franchisee since the economy reopened, nor have they convinced either of their current franchisees to open additional units. Perhaps, the global pandemic is to blame or perhaps it is their franchise fees.

Franchisor Pivot Option

This is where George's idea of pizza vending machines comes into play. One evening watching YouTube videos online about traveling to south east Asia George came across a pizza vending machine and was amazed. He scoured the internet all night long and could not find anyone else providing pizza to others through a vending machine. He couldn't sleep all night as ideas kept racing through his head on how he could capitalize on this invention. The very next day George was able to find a contact for a Pizza Vending Machine vendor in south east Asia. He asked if they would grant him exclusivity in the United States for their machine. Luckily for him, this particular manufacturer was focused on Asia so they granted him exclusivity for five years in exchange for purchasing 500 units within two years.

George informed the manufacturer that he would get back with them shortly. In the meantime, he began scenario planning different ideas which he could present to Ralph. In his mind, he wasn't actually sure what the future held for his Good Pizza franchisee brick and mortar stores as he was so enthralled by the idea of adopting pizza vending machines under the brand name.

The following is a list of options that George came up with and presented to Ralph in regard to the pizza machines:

1. Lease space in Big Box Retail stores, malls, etc. to place Good Pizza vending machines.
   a. Pros: increased name recognition could help sell more brick and mortar franchises
   b. Cons: expensive and time consuming if trying to expand quickly
2. Partner with Big Box Retailers or malls, etc. to place Good Pizza vending machines in store for a percentage of the profits.
   a. Pros: upfront costs do not include rent
   b. Cons: percentage of the profits is split and may far exceed market rent
3. Sell or lease pizza vending machines to businesses with an exclusive contract to supply the Good Pizza product.
   a. Pros: collection of upfront payment
   b. Cons: less control over the placement and use of the product.
4. Franchise the pizza vending machines to franchisees who will agree to a minimum number of units.
   a. Pros: upfront franchise fee and exclusivity to supply product for those machines.
   b. Cons: may be difficult to find franchisees and expand
5. Franchise the pizza vending machines by finding a Master Franchisee in each state who will agree to a minimum number of units that s/he can then franchise in state to fulfill.
   a. Pros: upfront franchisee fee and shared responsibility (i.e., Master franchisee will do the majority of the workload in their state)

b. Cons: may be difficult to find master franchisors and, if so, the firm is at their mercy in their specific state

"These are interesting options, but does this mean we abandon our brick and mortar franchisees?" Ralph questioned.

"Absolutely not! We are merely shifting our focus away from finding brick and mortar franchisees to pivoting our business model," George replied.

"The good old shift and pivot," Ralph responded with a chuckle.

"Oh yeah!" George proclaimed.

"Well, break down the costs for me," Ralph inquired.

"Here you are." George provided:

Estimated Initial Investment – Good Pizza Vending Machines

Name of Fee	Low	High
Master Franchisee Fee (Dependent on State)	$100,000	$500,000
Initial Franchise Fee	$5,000 (depending on number of units)	$10,000 (depending on number of units)
Pizza Vending Machine	$35,000	$50,000
Additional supply costs (dough, sauce, etc.)	$300	$500
Market Rent	$300	$1,000
Estimated Total (assumes operation of 1-5 pizza machines and does not take into consideration the Master Franchisee option)	$40,600	$61,500

Other Franchisee Requirements – Good Pizza Vending Machines

Name of Fee	Low	High
Net Worth Requirement	$10,000	$25,000
Cash Requirement	$5,000	$15,000
Royalty Fee	6%	
Ad Royalty Fee	4%	
Term of Agreement	3 years	10 years

Upon review of all the information, Ralph is not certain how to proceed and neither is George aside from the fact he wants to incorporate the pizza vending machines no matter what. They both are certain they want to continue with the franchise model as they invested a large amount of capital to incorporate and create their franchise system. Being first time franchisors, they both have agreed to hire a franchise business consulting firm to help them sort through their issues and develop a plan to move forward. They have prepared the following questions for their consultant and look forward to their response.

Discussion Questions

1. Are Good Pizza's current franchise fee hindering them from acquiring new franchisees? (i.e., Are their fees not in accordance with market rates for similar franchise systems?)
2. Identify issues that emerging franchisors need to consider as they attempt to grow their business via the franchise business model?
3. Compare Good Pizza's franchisee cost entry requirements with a local franchise pizza chain in your area? What would you recommend for Good Pizza to succeed with the original model?
4. Formulate other options Ralph and George did not consider?
5. Assuming the pizza vending machine strategy is sound, which of the five strategies presented would you investigate further and what resources would you need to determine the viability?

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