

SURE-FIRE **SITE SELECTION**

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How to avoid site selection failure... and a franchisee lawsuit.

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The recent Lenard's poultry case has sent shivers down the spines of every Franchisor across Australia. The psychiatric profession may have a jump in business as Franchisors seek counselling for sleepless nights, hot flushes and nightmares about being dragged into a legal case over site selection with an unhappy Franchisee.

The recent Lenard's case, and the Great Australian Ice Creamery case in Engadine from 7 years ago, show us that the Courts expect Franchisors to have undertaken reasonable due diligence in selecting sites and assisting their Franchisees to attain financial viability.

The decision by the Federal Court of Australia on the 17th of September, 2004 was in favour of the Bakers (former franchisees) against Lenard's Pty. Ltd. and their Master Franchisor for South Australia. The Bakers were awarded \$198,800, less a cross claim of \$21,416, with no decision at that time on interest or costs. The case is at present under appeal.

As a Franchisor, it would be prudent to look at the situation Lenard's found themselves in and see if you could be exposed in a similar way – would your Site Selection Process pass the test?

I am not a lawyer, and it is not my intention to analyse the case. (The full transcript is available on the Internet and runs for 55 pages). Instead, I will look at some of the pitfalls that these cases expose, and some ways to avoid or at least minimise them.

The Code of Conduct

Every Franchisor has obligations under the Code of Conduct to explain in their Disclosure Document that they have a process regarding site selection, but in my experience, many only pay lip service. If tested in a Court of Law, these could be seriously exposed.

The options include:

1. Run a full in-house property department
2. Have a combination of internal and external people to undertake the work
3. Have all property issues done externally.

Whatever the choice, the ACCC and the Code of Conduct require some formal process to be undertaken for issues surrounding site-selection.

Questions for Franchisors

The questions Franchisors need to ask themselves should include:

Internally

- Is there a process we use that can be accountable and reproducible for our decisions?
- Is there a work instruction in place we can show?
- Do we have some form of sales prediction tool we can rely on?
- Would these tools be explainable and hold up to rigorous investigation?

Externally

- What level of information should we give to a Franchisee to assist in selling our franchise?
- What should Franchisees be expected to do (that we can assist with) to give them comfort to proceed?

Property Department options

1. In-house property departments

Only very large companies can normally afford the luxury of a full, in house property department. As a former Property Manager within Caltex, we had around 10 people full time on property before the 1995 merger with Ampol. Companies like McDonald's, oil companies and the banks still tend to run in-house analysts within the property departments, and build or buy tools to assist their people's decision-making ability. For example, companies like MPSI from the US have been doing sales prediction modelling for the oil industry for years, and many oil companies in diverse markets subscribe to their products.

Some large franchise groups in Australia run internal property departments. I believe that in light of the Lenard's case, they need to evaluate the tools they use, and if they would stand up to legal examination.

2. Combination of Internal Employees and External Consultants

Many large and middle size franchisees work to a model with a combination of internal property managers, and external consultants to build models and produce sales predictions, demographic area reports and site potential reports which the companies can rely upon. This normally involves the external consulting company (such as ourselves) undertaking a Market Analysis and building a sales prediction model based on the learning's of the existing network. How the company addresses the knowledge with future franchisees is up to them, Companies such as KFC use this model.

3. Externally outsourcing all property issues

We come across some companies who chose to outsource all property issues including finding sites, negotiating leases, and justifying to the Board to proceed. The measure of this approach must be in the quality of what is delivered and cost compared to what can be delivered with either Models 1 or 2.

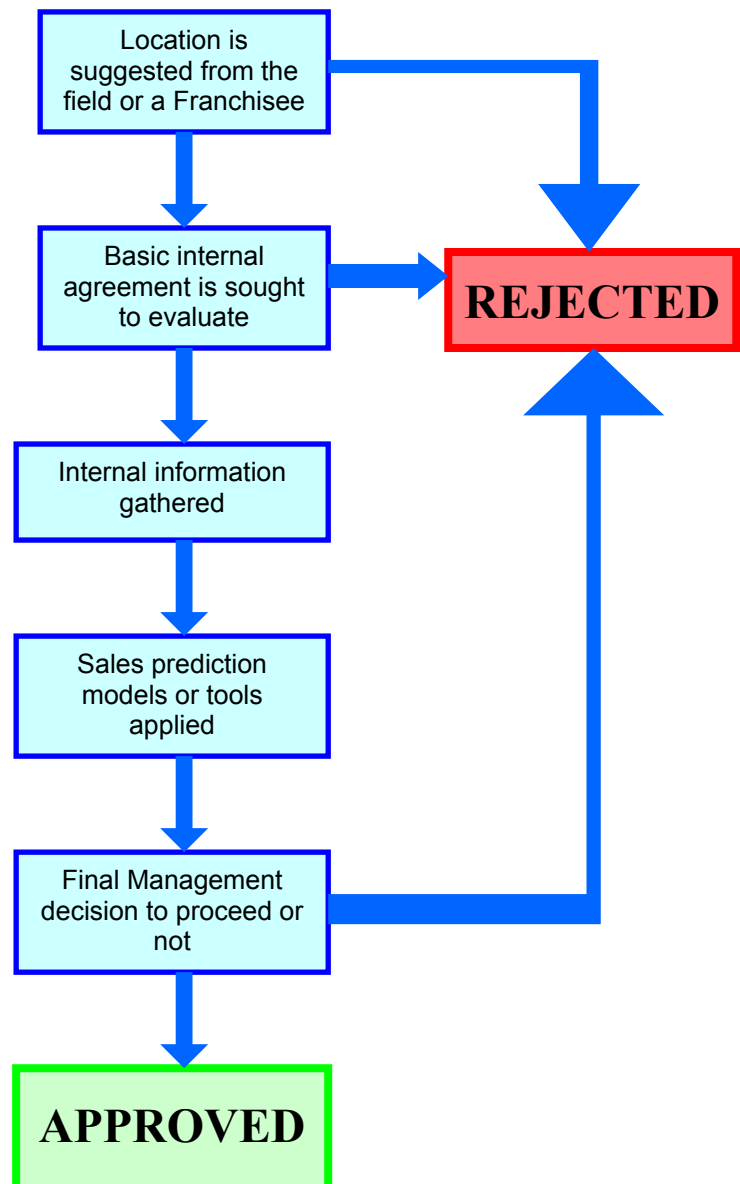
The Process

One way of ensuring a rigorous site-selection or territory distribution process and avoiding the fate of Lenard's and the Great Australian Ice Creamery is to take into consideration:

- Demographic analyses of the areas (both residential and business / employment)
- Power of the Shopping Centre, be it a Mall or a Strip
- A sales prediction based on the established drivers of the business

In addition, there should be a final decision-making phase that will take all factors into account. You might need to disregard the information from some areas of the process because of some special circumstance. An example of this is a coffee lounge on Rottenest Island, which performed very well but did not fit any normal sales prediction tools.

Once there is a formal process in place, you should be able to have some comfort or defence against a situation such as Lenard's currently face.



Sales Prediction Modelling

The core tool for any analysis is convincing or comforting yourself that you have some understanding as to what the sales of the business should be. If the top line or Gross Revenue is out by 100%, then all the numbers and profit projections on a Forecast Profit and Loss are worthless.

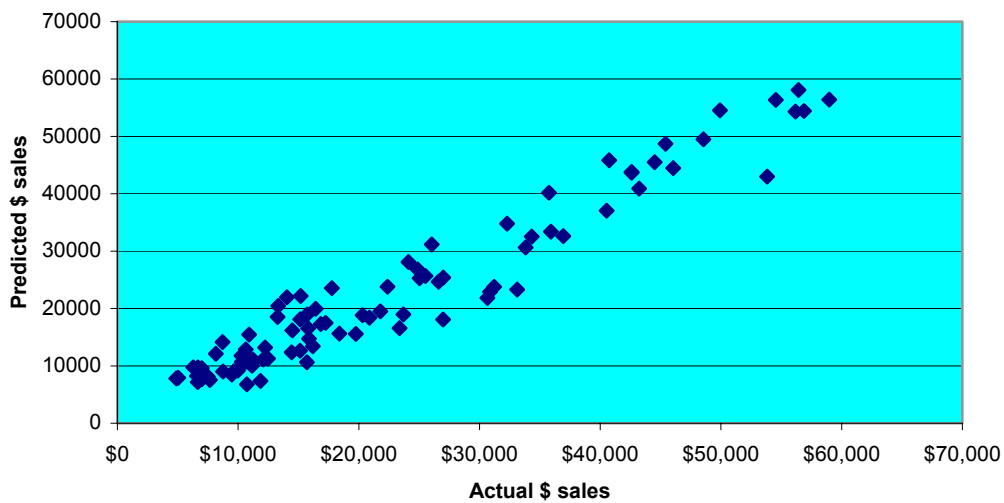
Companies such as ourselves work to give you some level of confidence in the Sales Projections you make internally, to convince yourself that a new location should proceed.

We believe that for established large networks (40+ stores), you can build a sales prediction model based on the sales being achieved by the network. This is done by a Market Analysis where:

- All existing stores are visited and surveyed. The survey can incorporate issues such as size of building, number of counters and tills, seating (if a food business), access, store visibility, signage visibility, parking spaces and convenience, nearest neighbours and other business generators, and many other items. A survey like this also produces digital photographs of all aspects of the site, and gives a benchmark for comparison of stores and standards for the Marketing Department.
- Around 400 demographic variables are extracted for each store in the network either at different radii, by sales territories and/or by catchment areas.
- Competition and generators are then measured to determine which categories of business have positive or negative effects on sales. Possible distance effects, wherein the competitive or generative effect is only active within certain radii, are also examined.
- 'Exposure' is approximated based on traffic counts, signage and visibility, and a measure of pedestrian volume and flow.
- Sales information for all applicable outlets complete the dataset, plus any internal operations measures where available.

Statisticians then go to work to look for the best variables that explain the sales that are being achieved. We normally obtain a Sales Prediction model that typically incorporates variables from each of the above categories (survey data, demographics, competition/generators, exposure, and internal data). Though no guarantee can be given of individual results, we normally obtain models that can be said to be 70 - 80% accurate. The more consistent a brand is, the more accurate we expect the results to be.

Actual Sales vs Model Prediction



The graph displays all stores in a network, each point showing where that store sits in comparing the actual vs predicted sales.

The sales prediction model aims at predicting the sales on mature or established sites, normally that has been open at least 1 year. In the oil industry, the sales of most service stations went through a 'ramp up' of 85% Year 1, 92% year 2 and reached its full sales potential (100%) in Year 3. Different businesses will have different ramp ups. In the fast food industry, we have seen cases where with big opening promotions some stores never again reach the sales level achieved in the first 4 weeks.

Once a Sales Prediction model is built and agreed upon, any new sites being considered can be run through the model to give a sales prediction at maturity. This may be done by the consultant, or internally if the company has all the necessary resources. Our experience is most companies tend to leave that with the Consultants as:

- They do not have the internal statistical expertise to run the models
- They do not have all the data necessary. Often the model includes some variables from Census 2001
- Staff changes, or staff are busy or on holidays, and they cannot keep up a 12 month service, but external consultants can provide these services all year round.

The Sales Prediction Modelling then becomes an integral part of the Approval process that a Franchisor undertakes. It should not be seen as the only part of the decision, as exceptions do occur, however it should be seen as a good "flag" as to what we should expect.

Though this is never 100% accurate, it should allow the Franchisor to have a set of ranges that guide further decisions in the Process. For example, a sales prediction in a range below the Network Average would provide a strong warning against proceeding, and special circumstances would need to be demonstrated to achieve approval. On the other hand, if a new store's prediction is in the top 25% of Network Average, then a higher level of comfort in approving the proposal can be felt.

This modelling can also act as a tool in evaluating the existing network for their actual sales against potential, and classifying the stores for certain Marketing actions.

Summary

The Lenard's case should make all Franchisors look at the Process they have in place for site selection. This case must be giving disgruntled franchisees heart that they may be able to lay the blame for financial failure back on their Franchisors, if they cannot show some logic and Process in how they went about Site Selection.

MISLEADING CONDUCT BY FRANCHISOR

Great Australian Ice Creameries

Peter Anthony Thompson
and Robyn Lesley
Thompson v Great
Australian Ice Creameries
of Australia Pty Ltd and
David Atchison.

Once again, franchisors have been before the court for misleading and deceptive conduct.

In this case, the applicants successfully claimed damages against the franchisor and its principal, Mr Atchison, regarding the suitability of premises in Engadine for the conduct of an ice creamery.

In this case, Mr Atchison provided relevant cashflows of the potential turnover of the site. The court found Mr Atchison had made representations as to average turnover, not as to particular amounts.

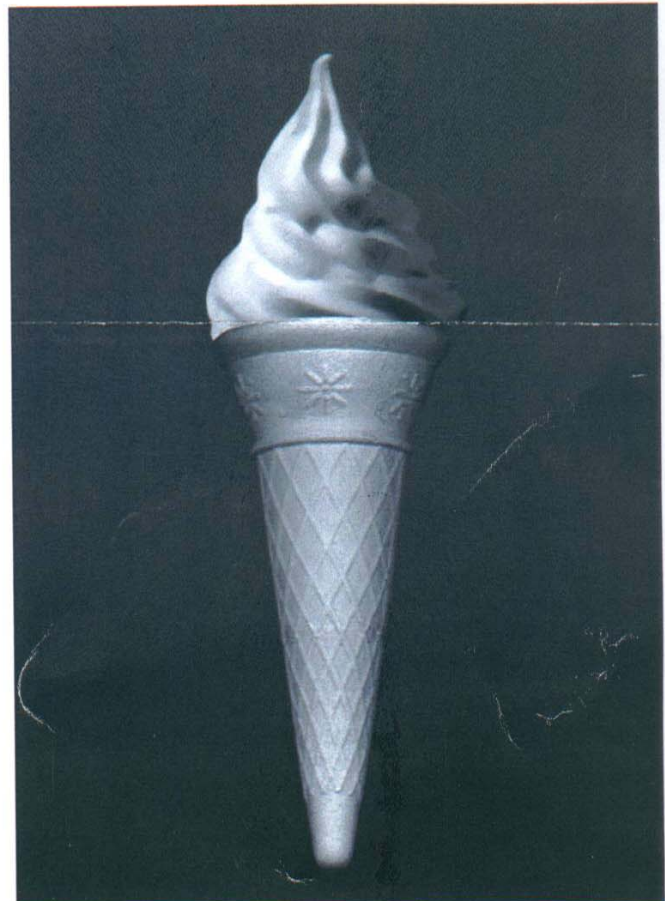
The question of the case revolved around a particular meeting at which representations were made as to the suitability of the site. Mr Atchison did not reply on specific recollections, but to his usual practices.

The case clearly highlights the need of franchisors to establish clear procedures for the induction of franchisees and proper site demographic studies.

With clear procedures as to documentation to be submitted to franchisees and record keeping, similar problems to what occurred with Mr Atchison and the Great Australian Ice Creameries could have been avoided.

The key issue in the case was whether the applicant represented the site was suitable as an ice creamery site. Issues about site demographics became a critical part in proof as to whether the site was suitable.

The judge found Mr Atchison's evidence as to the sufficiency of



customer numbers at the Engadine site was based upon a "feel" for the area generally derived from visits and experience.

The evidence established the population numbers were not sufficient to justify the statement that the site was suitable and, accordingly, the statement made by Mr Atchison lacked a "rational basis". It was this conduct that was the infringing conduct.

The judge ordered the applicants were entitled to the franchise fee of \$25,000 together with the price of the equipment, fittings and furnishings for \$87,700 less certain credit, being a net amount of \$98,835.

An additional amount of interest was payable and damages for trading losses of approximately \$20,000, and loss of proprietor's remuneration. The total bill, \$138,831 plus interest.

Mr Atchison was held **personally liable** under section 75(b) of the Trade Practices Act.