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Franchisee Use of Bootstrapping: *An Exploratory Study of Financing Decisions*

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According to the Census Bureau report in 2010, franchising accounts for 10.5% of businesses in the U.S. Despite the economic impact of franchising, little research examines financing decisions by franchisees in the startup phase of their businesses. We examine the use of debt financing, primarily bootstrapping, by franchisees to fund their businesses in the earliest stages of operation. The research analyzes data from the Kauffman Firm Survey (KFS), and we develop an exploratory model of franchisee activity. Consequences of the lack of loan availability will have detrimental effects on the success of franchise startups. Implications for practice, policy and future research are discussed.

The purpose of the current study is to consider the effect of financial decision making, specifically bootstrapping, by startup franchisees on organizational variables that commonly impact the success of a business. In the United States, franchising is a major contributor to jobs and economic stability. The latest report from the U.S. Census Bureau found that franchise businesses amounted to 10.5% of businesses with paid employees of 4.3 million establishments surveyed in 2007 (U.S. Census Bureau, 2010). This amounted to a total of 453,326 franchisee or franchisor-owned businesses out of the 4.3 million total establishments surveyed in 2007 (U.S. Census Bureau, 2010); over 77% of the businesses were franchisee-owned. Franchised businesses brought in almost $1.3 trillion of the $7.7 trillion in total sales for the 295 industries for which franchising data were collected. In addition, franchise businesses accounted for $153.7 billion in payroll and 7.9 million workers. Of these figures, franchisee-owned businesses accounted for $1.1 trillion in sales, $125.1 billion in annual payroll, and employed almost 6.3 million workers (U.S. Census, 2010). Limited service restaurants, known as fast food restaurants, had the highest number of franchise establishments measured by paid employees and the third highest percentage (59.1%) of franchise establishments, preceded only by new car dealers (100%) and private mail centers (67.9%). As of 2006, franchising in the U.S. included 1 out of every 12 retail businesses (International Franchise Association, 2006b).

FRANCHISEE STUDIES

Dant (2008), Cochet, Dormann, and Ehrmann (2007), and Welsh (2002) have long noted that more studies need to be done that focus on franchising from the franchisee perspective. Trends in franchising research continue to focus more on franchisors than on franchisees (Combs, Ketchen, Shook, & Short, 2011). Combs et al., (2011) point out that only two studies look at the reasons why individuals become franchisees rather than start an independent business (Peterson & Dant, 1990) or select corporate employment (Kaufmann, 1999). Traditional interest has been in understanding and explaining why firms select franchising as a means of growth, acquiring capital and addressing the agency or monitoring problems associated with multiple units.

Other major reviews of the franchising literature bring this missing link to the forefront (Combs, et al., 2011; Elango & Fried, 1997; Young, McIntyre, & Green, 2000). A few studies have focused solely on the franchisee (i.e., Dickey, 2003; Frazer & Winzar, 2005; Grünhagen & Dorsch, 2003; Grünhagen & Mittelstaedt, 2005; Sardy & Alon, 2007; Weaven & Frazer, 2003; Weaven, Grace, & Manning, 2009).

However, many of these studies emphasize comparisons of franchisees to other types of startups and small businesses rather than on business decisions of early stage franchisees. Another set of studies examines franchisee characteristics with an eye toward improving the selection process of franchisors.

The literature on franchising firms also studies franchisee survival since the promise of the franchise format for the franchisee is that a proven business model provides less risk. Many survival studies exist (Bates, 1998; Stanworth, Purdy, Price, & Zafiris, 1998), but the term of failure or survival has come under criticism. Instead, a broader concept, exit, is now studied. Frazer and Winzar (2005) propose a model of franchisee exits, and one component is investment, along with franchisor experience, franchise system size, support of hands-on operations, conflict and industry. They found that franchisees often abandoned the franchise altogether if the amount they had invested was not high. Franchisors have long adopted the belief that the higher the franchisee investment (including an initial franchise fee), the more the franchisee will work to recoup their investment. Indeed, a relationship between investment level and survival of the franchise has been found in previous research (Bates, 1995).

Franchisees have been compared to nascent entrepreneurs using the Panel Study of Entrepreneurial Dynamics (PSED), a national database from the U.S. with 830 nascent entrepreneurs and 431 comparison group members (Sardy & Alon, 2007). Among the nascent entrepreneurs were 52 franchisees. Compared to nascent entrepreneurs, franchisees had less industry experience (one year vs. four years), education was comparable, franchisees did not seem to value their previous experience as much, franchisees had fewer net assets and were less well capitalized, franchisees expected their first year income to be less variable than did the nascent entrepreneurs, and franchisees were less confident that they could make their business a success. For the franchisees, having less capital was attributed to the franchise fees at startup and moderately well-defined startup costs (Sardy & Alon, 2007).

FINANCING STUDIES

The purpose of the current study is to consider the effect of financial decision making, in particular bootstrapping, by startup franchisees on organizational variables that commonly impact the success of a business. The concept of bootstrapping is used to assess activity in many functional areas, including staffing, human resources and marketing as well as finance. Bootstrapping is defined as finding creative opportunities to launch and grow new ventures (Cornwall, 2010). The term bootstrapping dates to the 1900s and refers to the act of pulling oneself up by the bootstraps; entrepreneurs who start and grow businesses with limited resources employ bootstrapping (Cornwall, 2010). We argue that enhanced understanding of financial data, as it relates to decision making of these startup franchises in the first five years of their business, could lead to higher success rates of the startups and a better return on invested capital. Specifically, this study focuses on new franchisees' use of financial bootstrapping including founders' financial decisions to personally supply equity or use personal debt financing through the use of credit cards.

Until recently, bootstrapping by small firms and entrepreneurs was not examined (Van Auken, 2005). Some studies note that traditional finance theories may be an oversimplification of the objectives of small business owners (Gibson 1992; Kuratko, Hornsby & Nafziger, 1997; Monroy & Folger, 1993). Others identify the need for new theoretical development in entrepreneurship in general (Alvarez & Barney, 2004; Phan, 2004) and in entrepreneurial finance in particular (Schwienbacher, 2007).

Entrepreneurs employing internal financing rely on debt financing, including the use of credit cards, personal loans and second mortgages, to develop their business. Although entrepreneurs can use bootstrapping in any organizational function such as marketing or human resources, many studies focus on the use of financial bootstrapping because financial resources make the acquisition of human, technical and other resources possible (Brush, Carter, Gatewood, Greene & Hart, 2006; Harrison, Mason & Girling, 2004).

Studies identify a number of reasons entrepreneurs utilize bootstrapping. This approach is considered by some as a sign of creativity (Bhide, 1992, 2000). More commonly, researchers view bootstrapping as filling the gap when traditional sources of capital are scarce (Gibson, 1992; Winborg & Landstrom, 2001). Capital may be short for a number of reasons; for example, lack of business knowledge and experience (Timmons, 1999; Van Auken, 2000, 2005) or gender in that women may find greater difficulty in accessing capital sources (Brush et al., 2006).

Characteristics of the business and investment preferences of lenders may also influence the availability of capital. Low risk businesses are preferred by lenders and high growth businesses have greater access to equity capital (Van Auken, 2005). Some research indicates that the entrepreneurial stage will also be a factor in financing decisions by franchisees and by lenders (Schweinbacher, 2007). For example, very early stage owners are likely to use bootstrapping to fund their businesses; serial entrepreneurs may use bootstrapping and have access to angel capital; high growth and profit maximizing businesses will have greater access to venture capital (Schweinbacher, 2007).

Research on the venture capital industry finds that venture capitalists seek very large investments due to the magnitude of their funds and the small number of partners per firm who supervise the funds. In addition, they are active investors, taking board roles and overseeing the business to protect the returns on their investments (de Bettignes & Brander, 2007). Because of the size of the investment, it is highly unlikely that nascent ventures are eligible for venture funding, with the exception of technology firms. Lifestyle business owners are likely to self-fund in order to restrict entry of outsiders and active investors.

Past studies show that franchise businesses have some advantages over independent startups (Litz & Stewart, 1998). For example, a unique combination of tangible and intangible assets creates a competitive advantage for franchisees (Hoffman & Preble, 2003). In addition, economies of scale account for increased efficiency of franchisees over independents (Bronson & Morgan, 1998).

Our study is exploratory due to the nature of the available data from the KFS available for public access (www.kaufman.org/research). We generalize from the research on early stage entrepreneurs to early stage franchisees. The research literature is the foundation for propositions and the development of a future model that will aid in understanding outcomes for new franchisees. Based on the previous discussion, the following four propositions are offered concerning franchisee characteristics.

Proposition 1: A majority of franchisees will have a college education.

Proposition 2: A majority of franchisees will have from one to four years of prior business experience (Sardy & Alon, 2007).

Proposition 3: A majority of franchisees will perceive that their ventures possess a competitive advantage relative to other organizations.

Proposition 4: A majority of franchisees will rely on bootstrapping (i.e., financial decisions to obtain debt and equity financing from personal resources rather than external sources).

METHODOLOGY

SAMPLE

The Kauffman Firm Survey (www.kaufman.org/research) is the largest longitudinal study of new businesses to date (Robb, Reedy, Ballou, DesRoches, Potter & Zhao, 2010). KFS is a panel study of 4,928 new businesses founded in 2004 that mirrored the true population according to Dun & Bradstreet. Data were collected using both web-based and Computer Assisted Telephone Interviews (CATI) which assessed several aspects of the businesses including the nature of new business formation activity (franchisees); characteristics of the strategy, offerings, and employment patterns of new businesses; the nature of the financial and organizational arrangements of these businesses; and the characteristics of their founders/partners. The KFS survey included 109 franchises. The franchise sample (2.6% of the total KFS dataset) closely matches the reported total franchise to new startup businesses ratio of 3.3% reported in the economic research study conducted by PricewaterhouseCoopers for the International Franchise Association Educational Foundation (2008). The KFS survey accessible for public access was used for this research. Because this survey is accessible to the public, some information was not available; for example, amount of revenue, amount of profit, amount of tax payments, and a number of additional variables were excluded or recoded for the public access survey.

MEASURES

The following variables were examined in the study:

Education: Years of education were recoded to high school, some college, bachelor's degree and graduate work.

Prior Work Experience: Respondents reported years of previous experience.

Competitive Advantage: Respondents reported whether they perceived the business to have a competitive advantage. (no, yes)

Financing Decisions:

- *Equity*:
  - Equity Investment: self, spouse, family (no, yes)
  - Equity investment: angel, government, other (no, yes)

- *Debt*
  - Business loan: family, employee, other (no, yes)
  - Business line of credit (no, yes)
  - Business credit card (no, yes)
  - Personal credit card (no, yes)
  - Personal loan: bank or other (no, yes)

Franchise fee: estimated from NAICS code. (www.census.gov/eos/www/naics)

Industry characteristics: competition, uncertainty estimated from NAICS code

FINDINGS

We look at the use of debt financing, primarily through bootstrapping, by franchisees at the beginning of their business operations. Franchisees from the Kauffman Firm Survey (KFS) of nascent entrepreneurs in the startup phase were examined in terms of education, experience, perception of competitive advantage and financing decisions.

For education, 11.9% of the respondents hold a high school or technical degree, 23.8% of the respondents have some college or an associate's degree, 35.8% hold a bachelor's degree and 25.7% have graduate work including 20.2% with a master's degree and 2.8% with a professional degree or a doctorate. The level of education in this sample is somewhat higher than in earlier studies.

Respondents report varying years of work experience. A total of 24.8% have no work experience, while 41.3% have one to five years of work experience. Six to 15 years of work experience is reported by 19.1% and 13.9% have more than 15 years of experience. These figures support earlier studies that find franchisee experience varies widely, and there exists a sizeable percentage of franchisees with limited work experience.

Perception of a competitive advantage finds that 85% of respondents answer that they feel their personal business has a competitive advantage. This figure supports the widely held notion that a franchise business with a proven track record, a recognized brand and a set of tested operating procedures is likely to be a strong competitor in the marketplace.

The financing strategies show the expected pattern. Of the roughly 92 franchisees responding to the questions regarding outside equity, an average of 80% or more reported no outside equity investments (angels, venture capital, government or other organizations). On the other hand, 86.2% of all 109 respondents report their own equity investment. In contrast, there is little equity investment (3% to 6%) by spouses or family.

The findings for debt financing show a pattern of bootstrapping. Less than one-third of the respondents secured a business loan. The numbers increase to 40% for the use of a business credit card and over 50% for the use of a personal credit card. In summary, the new franchisees relied on their own credit and personal loans to finance the business.

DISCUSSION AND IMPLICATIONS

The findings from this exploratory study indicate that new franchisees pursue the expected financing strategy of bootstrapping. Although typical for very new entrepreneurs, it is also a very risky approach. The current study includes personal characteristics of franchisees, such as education and experience along with a perceived assessment of a competitive advantage. Our findings indicated that participating entrepreneurs are well educated (over 60% have at least a bachelor's degree), have a varied history or work experience, and feel positively regarding their business's competitive advantage. Despite these characteristics, most rely heavily upon bootstrapping.

A focus on financing decisions and outcomes has implications for both future research and for practice. Future research using an expanded model could examine the extent to which future business success of these franchisees will be moderated by franchise fees, franchisor practices and industry characteristics. The challenge will be to test the model with longitudinal data on franchisee exits and continuance (Frazer & Winzar, 2005). In addition, we hope to extend the current research by testing a model comparing franchisees with startups in non-franchise business areas, examining early and later stage financing decisions, and contrasting franchise fees with business costs paid by non-franchisees.

In addition, franchisees often state that fees are too high for a startup business. In contrast, franchisors say that their fees are carefully calculated and are fair for the value received. Fees are often studied under the concept of franchisor value (Grunhagen & Dorsch, 2003; Kaufmann & Lafontaine, 1994; Frazer & Winzar, 2005). Future studies may be able to provide answers to this important difference in opinion regarding the value a franchise provides to new franchisees.

The current financial crisis in the U.S. will have a detrimental effect on early stage franchisees. With the change in credit card regulations at the federal level, banks and credit card companies have responded by increasing credit card rates with notice. Previously, the credit card companies were able to raise the interest rates without timely notice to cardholders. However, increased rates will have a detrimental effect on startup franchises that have relied heavily on credit card financing because these startup franchises will pay higher interest and are likely to have a greater chance of failure. They rely on credit card financing because they do not have access to alternative financing options. Other types of financing, including SBA loans, must be more readily available to startups in the current financial environment. Franchisors, in order to ease the credit situation, may have to provide more financing options to their franchisees. For example, providing more resources for the franchise location, the franchisor is protected since the real estate provides collateral for the loan. In term of long term strategic planning, the franchisor can restart the franchise location if the franchisee fails by opening a company-owned outlet or reselling to another franchisee.

Our findings support the proposition that franchisees are borrowing from credit cards in the early stages of their venture. Therefore, franchisors should consider re-evaluating the initial fee structure given the difficult economic environment to encourage franchise survival. This may be a temporary solution that would reduce the financial pressure on new franchisees.

LIMITATIONS

The major limitation of our study is that it is an initial foray into the study of financing among franchisees in the startup phase. There are no actual outcome measures to test a predictive model that examines the impact of the use of debt financing or other means.

A second major research limitation is that the KFS data is highly focused on high-tech firms. Also, our analysis is limited to the first year (2004) of five years, and a finite number of variables were examined. We restricted this analysis to the first year because much of the financial data was not completed by the franchisees, and nearly one-third of the franchisees dropped out over time, an issue generally involved in the analysis of panel data. Another major limitation is that the database is only U.S. businesses. Global data sets also need to be analyzed for similarities and differences with the U.S. sample. Additionally, franchisees should be analyzed at various stages of the business development process to best determine probability of success and return on invested capital.

CONCLUSION

Future studies could compare a wider range of financial data for franchisees. The results with U.S. franchisees can be compared internationally with samples in other countries to examine how global franchisees approach financing of their businesses. An interesting research question is whether the results are comparable and if findings are generalizable from country to country. Industrialized versus emerging countries could also be compared on these financial variables to help us determine how to improve the survival rates of franchised businesses and assess which variables improve the chance of success in emerging versus industrialized economies. In addition, what other variables that are excluded from this survey should be considered? Are these variables different in international markets, whether they are emerging countries or industrialized countries? Future studies should examine the impact of global financial market on international franchisees and franchisors and their ability to access capital.

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