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Franchising as it Relates to the Hospitality Industry

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Franchising as it Relates to the Hospitality Industry

Cassidy Morgan
Honors Thesis
HMGT 799
Fall 2016

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Introduction

Franchising is a fast growing business model in the United States. It aids in the stimulation of the economy, creating jobs and expanding businesses nationally and internationally. With \$1 trillion being generated by franchised businesses, it is impossible to ignore the effect of franchising on the U.S. economy. The decision to turn an independently owned business into a franchise is developed by the company owners after weighing the implications of possibly relinquishing rights to many of their units and their profits in exchange for the ability to expand their company at a low cost to the owners and only a percentage of profits. Although franchising a business is possible in many industries, it is especially prevalent within the hospitality industry. While it may seem like an extremely lucrative and sound decision, franchising is not the perfect fit for every large company. Seeking to find the potential benefits and drawbacks for both franchisees and franchisors will aid in deciding whether or not a company should begin to franchise their business, or to keep all of their units brand owned. It will also determine the potential implications of purchasing a franchise, rather than going into business independently.

General Franchising

Franchising is a term used to describe a business model where companies sell the rights to their business to owners and operators who, for a cost, operate their business using the company's brand. This gives the company the ability to grow and expand very quickly. The franchisee is the owner who pays for the rights and terms to run the business. The franchisor is the company that sells the rights to the business and

receives fees and royalties in return. There is argument among historians as to who is credited with the first real franchise, some dating it back to Benjamin Franklin in the late 1700s (The History of Franchising). However, one common theme remains static for all hopeful franchisors: the desire to grow a business at a fast rate great distances with little initial capital from the parent company.

Franchising contributes greatly to the United States economy and represents a large group of businesses. Today, there are over 800,000 established franchised businesses in the United States with an additional 150,000 international franchises that follow the United States franchise system. These businesses generate over \$1 trillion in annual sales. The sales of franchises represent 40% of all retail sales and 17% of the gross domestic product. Any successful business can be franchised and there are sixty-five recognized industries in franchising, including: healthcare, travel, accounting, and education (Franchising: An Entrepreneur's Guide).

The most commonly known franchises are businesses within the hospitality industry. Restaurants and hotels are extremely popular franchises due to their longevity in their respective industries as well as the high rate of return on an investment in either industry for the franchisee. When executed successfully, lodging and restaurant franchises can be profitable for both the franchisee and franchisor. Some early franchises dating back to as early as the beginning of the 1900s include: Howard Johnson, White Castle, Kentucky Fried Chicken, and Dairy Queen. Owners of these businesses were limited in outreach and their ability to expand their business. They used early methods of franchising as a way to create a national brand that was well

known among the everyday consumer. This way, they could garner loyal customers in many locations despite their inability to travel long distances or the technology needed to single handedly manage restaurants spread across the country. While hospitality remains a well known industry for franchising, the 2016 Top 10 Franchises from Entrepreneur's Franchise 500 list includes only six hospitality companies. Jimmy John's, Subway, McDonald's, and Hampton Inn remain as highly coveted franchises but retail, fitness, and insurance companies also topped the list this year (2016 Top Franchises from Entrepreneur's Franchise 500 List). Franchising is a business model that can be used in many industries seeking to expand quickly and raise profits.

How To Franchise Your Business

In terms of logistics, it is possible to franchise any business if you a business owner has the capital and willing franchisees. However, it is not feasible or realistic to franchise just any business. A business should have a stable foundation before attempting to expand and garner potential franchisees. The conditions under which a potential business franchise should fall include the ability to be credible, unique, teachable, and provide an adequate return on investment. Having each of these qualities should help to guarantee a successful franchised business. The business must garner enough popularity within the market to create an appealing brand image that will attract franchisees who wish to invest in the company. Without a popular brand image, the franchisee is virtually paying royalties and receiving nothing substantial in return from the franchisor. The impact on customers using brand recognition should be what brings in a large customer base and increases the value of potential franchised

locations.

Once the company expands and attracts loyal customers, the owners can consider franchising as a way to expand their business without using an abundance of their own start up capital. In order to begin to franchise a business, one must have a successful and solid business model in place that can be replicated. Then, one must consider if their business has longevity in the market, a competitive product to enter the market with other competition, and their product or service is not specific to one area or region and will be successful on a national scale. Despite existing competition, it is possible to create a new franchise in a market that already appears saturated as long as the product or service is successful enough to stand alongside the competition (Franchising: An Entrepreneur's Guide). For example, Wendy's, Burger King, and McDonald's are essentially very similar in their business and products. Expansion through franchising can begin when there is a solid plan in place as to what structural changes will be made throughout the company in order to make room for many new outlets. This plan will be overseen by financial advisors and support staff to ensure its success. The process of turning your business into a franchise can take years in order to determine the proper path for expansion of any company. It is important to have an accurate estimate of the company's financials before, during, and after a potential expansion in order to predict the financial stability of the company throughout the process.

With the intention to franchise in mind, company owners must prepare the operations procedures to accommodate their newly franchised locations. Since the

franchisees needs to adapt the existing service model and brand image, a proper operations manual must be strategically developed and given to each newly franchised property. This way, there is one uniform way to execute business in each location and eliminates possible errors and misunderstandings between the franchisor and franchisee. The manual can include employee training methods, brand standards, rules, policies, procedures, and regulations. Each will be specific to the brand itself and every franchise creates their own version of this to provide to franchisees when they initially start a new location.

Next, the franchisor will need to market and sell the franchise to entrepreneurs to incentivize them to purchase franchised locations. It is important to find individuals with enough start-up capital to be able to fund the expansion of a new location. These individuals will seek out businesses that have low risk and high return so it is important to show potential franchisees that opening a franchise will be lucrative to them in the long run despite the large initial start-up and royalty fees. Also, it is extremely helpful if the potential franchisees are knowledgeable in business practice, either in schooling or experience. Their knowledge of the industry will help ensure success of the location because they will have prior experience to use as a guide in their work efforts. The success of the franchised location is important to the parent company because that location will reflect on the company as a whole. A customer with a negative experience at one franchise does not blame the franchisee, rather they spread negative feedback about all of the company's locations as a whole. Therefore, business experience is arguably as important as initial capital investment when it comes to choosing a potential

franchisee because a poorly managed franchise location has the ability to tarnish the reputation of the entire brand.

Once a franchisee has been chosen, the company has expanded to the new location, and the franchisee has been provided with all of the brand information and operations manuals, it is up to the parent company to keep a watchful eye on the franchise and maintain their relationship. The franchisor must continue to service the franchise and keep the location up to date on any changes within the company's policies and procedures. While the franchisor is not dealing with daily operations, they are working behind the scenes with advanced researchers in marketing and product testing to provide the best available resources to their franchisees to prepare them for success. The franchisor will ensure quality standards of the franchise unit. While most of the operational duties are left up to the franchisee, maintaining a relationship with the franchise and servicing any struggling franchisees will positively impact the entire company. Another role of the franchisor is to continually sell more franchises to potential franchisees and expand the company further into more locations to increase the brand image. Spreading the brand image on a larger scale and creating a positive reputation among consumers will bring more people to each brand location, which increases the value of that franchise. For example, someone who tries McDonald's for the first time in New York will be likely to visit one in Los Angeles if they had a positive experience, as they know what to expect the second time. The consumer will likely never realize that both of these restaurants could be owned by completely different franchisees if the

franchisor provides each location with the proper tools to ensure operational success and streamline the business offerings.

Legal Implications

There is an abundance of legal implications that stem from the decision to franchise a business. Early laws to protect franchisees were put into place in the 1970s. Most laws regarding franchises are put into place to protect franchisees from termination or nonrenewal of contracts. There are strict guidelines in place that define when a franchisor has the ability to terminate or not renew a franchise agreement. In 1979, the Federal Trade Commission created the FTC Rule requires proper disclosure from the franchisor before a franchise agreement is signed (Franchising: An Entrepreneur's Guide). This allows the franchisee to make well-informed decision regarding investments into a franchise. The FTC Rule works to prevent any fraudulent misrepresentation of financials from the parent company that could cause a franchisee to enter a bad relationship.

The Franchise Disclosure Document (FDD) is a document that “provides prospective franchisees with information about the franchisor, the franchise system and the agreements they will need to sign so that they can make an informed decision” (International Franchise Association). It is a lengthy, legal document that includes twenty-three items that define all aspects of the franchise agreement. These items include information about fees, investments, restrictions on vendors, financing, computer systems, training, copyrights, dispute resolution, financial statements, contracts, and receipts to name a few. The Franchise Disclosure Document is agreed

upon and signed by both the franchisee and franchisor, creating a legal relationship between the two parties before any business relationship can begin.

There are also contracts between the franchisor and franchisee that allow developers to build a number of franchised businesses in particular markets (Franchising: An Entrepreneur's Guide 337). This is called a contract area development agreement. A subfranchising contract is another expansion program that "grants a subfranchisor the ability to sell individual franchises to individual investors in a defined region" (Franchising: An Entrepreneur's Guide). It is important that throughout the franchising process both the franchisor and franchisee are protected by law from any disputes that may arise between the two parties. This creates a safe business environment that potential franchisees are more likely to invest in because they are protected by legal documents and contracts.

Intellectual property is an important aspect of franchising. It includes the intangible assets of a company such as their trademarked logos, copyrights, and patents. The value of a company's intellectual property is so great because it represents all aspects of the business in a single logo. This is applicable to franchising because the franchisee will use the rights to the trademarks in order to receive the brand recognition of the parent company on their franchised unit. Trademarks, patents, and copyrights are valuable because they protect the value of the company's ideas by law. No other company can have the right to the brand's intangible values unless they are owned by the company or franchised by the company (Franchising: An Entrepreneur's Guide). The ability to utilize a company's intellectual property is one of the largest benefits of

franchising and is a large part of what a franchisee is paying for when they join a franchise agreement.

Franchising in the Hospitality Industry

Today, some of the most popular franchises are fast food restaurants. McDonalds, Subway, and Dunkin' Donuts are a few big names that made the top 10 in the list of Top Franchises for 2016 (Entrepreneur.com). It can be an extremely lucrative business for a franchisee to open a McDonald's. There are currently over 30,000 McDonald's franchises internationally whereas the company only owns about 6,000 units (Entrepreneur.com). It is estimated that a single McDonald's storefront earns about \$2.5 million dollars per year (Business Insider). This makes McDonald's the second highest grossing chain in the United States, behind only Chick-Fil-A. However, opening a McDonald's franchise is not easy or cheap. McDonald's requires potential franchisees to have \$750,000 in liquid assets and estimates the building costs to be between \$100,000 and \$2 million, depending on the location specific real estate costs, size of the property, and building taxes (Business Insider). This cost also includes the kitchen equipment, dining furniture, landscaping, and restaurant decor.

When acquiring a franchise from a hospitality company, it is likely that it comes with a large, loyal fanbase, loyalty programs, "sister" properties, logos, and brand standards. For instance, W Hotels have their own unique verbiage used by all employees across international cities, franchised or otherwise. They also have a signature scent used in all public areas, fonts specific to only their brand for any signage, and uniforms that are the same for any property. Franchisees must learn and

utilize all of the operations materials provided to them in order to maintain a streamlined exterior in the eyes of the consumer. Franchising a W Hotel grants franchisees access to the Starwood Preferred Guest program, a Starwood Hotels loyalty program to gain and keep loyal customers and incentivize guests to book direct with the hotel rather than on third party websites. This international loyalty program is one of the biggest hotel loyalty programs in the world and utilizing the popularity of the brand and its loyal members is a perk of franchising within the hospitality industry, specifically with a Starwood hotel.

Franchised Companies: Benefits for Franchisor

If a franchisee is willing to take the leap and invest in a franchise, this investment is benefitting the franchisor as it is millions of dollars that the franchisor does not need to spend on creating new locations. They can begin a nationwide expansion without necessary capital, because it is paid for by the potential franchisees in start-up fees. There is no debt or cost of equity collected by the franchisor in initial building costs. The franchisor, however, is not relinquishing all of the profits to the franchisee. The franchisee must pay the initial startup fees to the franchisor and then franchise fees based on a percentage of sales. In the case of McDonald's, an initial startup charge of \$1-2 million plus a monthly 4% royalty fee is received by the franchisor (Entrepreneur.com). The franchisor does not have to worry about managing the unit, as a franchisee with millions at stake in their business will do their best to perform well. A franchised unit operated by an owner is usually more motivated than a company-employed manager because they have personal interest in the success of the

unit (Franchising: An Entrepreneur's Guide). The franchisee is also the name on the lease and many building and loan contracts, eliminating any liability for the franchisor. When the franchisor does not have to invest in expansion, they can use the company's capital elsewhere and invest in other aspects of the business which will benefit all units in the long run. Once the business is up and running, the franchisor evaluates performance standards and receives royalty checks from their franchisee. In return, they provide the franchise with an operation manual, company standards, marketing, and the rights to use the brand name. It is important to maintain a relationship with the franchisees to ensure they are running the franchise to the standards set by the company.

Drawbacks for Franchisor

Notably, many popular "chain" companies choose not to franchise their businesses. There is a difference between a chain and a franchise, and not all chains are necessarily franchised. In these cases, each of their units is owned fully by the parent company. While there are many incentives to franchising, choosing not to franchise is not unheard of among businesses. Companies that decide against franchising do so to keep the control of their business tightly under their thumb, rather than relinquish it to other owners. Many businesses that are against franchising feel that they receive enough profits and they can grow without franchising, and the act of franchising is not worth the larger risk of losing partial control over their business. Franchisors must consult with their franchisees on any changes in policies, company missions, and market strategies to avoid any legal implications. Whereas an

independent business would have the freedom and ability to make any changes at the will of the company's owners (Franchising: An Entrepreneur's Guide). Two well known United States food chains that choose not to franchise their businesses are Chipotle and Starbucks (domestically). While many have questioned the two companies on their decision, both companies seem to hold firm in their choice and do not appear to have any active plans for future franchised locations.

Chipotle believes there is no reason to authorize franchising because they do not need additional capital from investors to aid in their start up of new location. They have plenty of demand for filling management positions in their units so they find their managers to be extremely motivated. Chipotle also enough of their own capital to start new storefronts without any help from outside investors looking to obtain a share of the profit (Business Insider). Although many franchise agreements contain strict rules to how a franchise must be operated, Chipotle believes franchising their business will dilute their service model and take away from guest experiences. They feel that they are the most capable of handling each store and do not wish to risk giving control to outside parties. Chipotle receives such large revenues from each restaurant that they feel franchising would reduce their earnings and they are not willing to trade their large revenues if only for a small percentage of profits. Chipotle's gross profit has been steadily increasing since 2013, earning over \$1.7 million in profit at the end of 2015 (Yahoo Finance). Due to recent current events that have created negative news surrounding Chipotle's ingredients, they believe that by refusing to franchise they are able to maintain a tighter control on food sourcing and inventory control.

Starbucks, despite their hugely popular fan base and abundance of locations, also chooses not to franchise domestically in the United States. Their reasoning is solely based on aggressively guarding their brand and protecting it from any outside influence. Starbucks has no desire to give their heavily coveted title to those who are just looking to make a profit using their brand name. However, they do allow licensing agreements to businesses so that small kiosks in airports or schools can sell Starbucks' brand coffee. It is unlikely that Starbucks will ever be willing to release rights to their brand for franchising in the United States in the foreseeable future because they may lose money and control on a franchising deal by relinquishing rights and sharing profits with others.

Despite their unwillingness to franchise in the United States, Starbucks has begun the process of exploring franchising options overseas. The company felt that franchising could give them access to areas and countries in which their executives have very little familiarity regarding business practice (Wall Street Journal). With franchising, Starbucks will be able to enter many international markets in locations they had previously not considered. Franchising internationally and utilizing international owners and managers will give Starbucks more insight into a different market segment from someone who is a native citizen of that country.

However, Starbucks is not giving rights to their brand to just anyone with the capital to open a franchise. Becoming a franchisee for Starbucks is an extremely strict, long, and thorough process. Starbucks executives flew overseas to meet with potential franchisees over family-style dinners, taking place right in the homes of potential

franchisees. They really emphasize the desire to get to know potential franchisees on a personal level before they allow them to join Starbucks. Initially, Starbucks hopes to only open about twenty five store fronts overseas that will be owned by only two or three owners (Wall Street Journal). This way, they are not diluting the brand at an alarming rate and a few franchisees will remain control of the franchises and focus on the Starbucks brand. A small number of initial franchises will give Starbucks the opportunity to track progress and measure the success of the franchises in order to aid them in planning additional franchises in the future.

Benefits for Franchisee

Joining a franchise agreement can be enticing to a potential franchisee due to the higher likelihood of success with the brand recognition of a well known company name. The established product or service speaks for itself and attracts loyal customers who are comfortable buying a product or service with a familiar name. Franchising gives a potential business owner the opportunity to attempt business in an unfamiliar field successfully, because they are given the tools and guided to success by the franchisor. The franchisor provides site selection, advertising, remodeling, store design and layout, inventory, equipment, furniture, and more to aid in the franchisee's start up (Franchising: An Entrepreneur's Guide).

Although there is a cost to starting a franchise, there is less operating capital involved than if a potential business owner were to start up independently. A franchise will require less inventory and the parent company has information about proper stock levels to avoid waste. Starting independently involves many architects and contractors,

which will take a lot of initial capital and time. Franchised businesses also have business and health insurance through the franchisor, so the costs of both would be lower than if an independent business owner approached the insurance company alone. Franchisors have highly qualified research teams that focus on new product development, so when a new product is introduced to a franchised business it is likely to be successful in comparison to an independently made decision.

Drawbacks for Franchisees

Initially, many potential franchisees may be turned off by the cost to open a franchise. The average initial fee is usually around \$35,000 to start up a franchise (Entrepreneur.com). Additionally, a franchisee must pay royalty fees based on profits, a marketing fee, and purchase supplies only from particular retailers despite the potential cost being higher than other suppliers. Usually, it is individuals with an entrepreneurial spirit that seek to go into business for themselves by franchising. In the case of franchising, an entrepreneur will be limited in the amount of freedom and creativity they have in their business. To some, this is an advantage, but those seeking independence in their business structure will not find it in a franchise. Franchisees must follow strict rules set forth by the franchisor regarding training, hiring, procedures, policies, uniforms, operations manuals, supplies, and purchasing. They can only sell the products or services that have been given to them by the franchisor. Franchisors are able to define all rules for the franchise agreement in the Franchise Disclosure Document, which legally binds the franchisee to agree to follow all of the guidelines set in place by

franchisors. The lack of uniqueness in the business can be a turnoff to potential franchisors.

Another drawback faced by franchisees is the fast changing reputation of the franchise among consumers. Poor performance by one franchisee at a different location will affect the consumer's opinion of all franchised locations, not just that particular one. All franchises can be greatly affected by negative experiences at another location. For example, a consumer who receives a poorly made product or bad customer service at one specific location will no longer visit other locations because they are expecting the same bad product. When talking to their peers, they will usually not specify the location in which the bad experience happened, rather they will just sweep all units together under one umbrella. For this reason, it is important that the franchisor enforces strict rules and policies onto their franchisees. When all franchisees follow the same guidelines, the product and experience is uniform among all locations which eliminates the chance of "one bad apple ruining the barrel" (Entrepreneur.com). A potential franchisee should do research into the franchise that they choose to invest in because there are many reviews online that will present any possible issues with the franchisee/franchisor relationship.

Conclusion

Making the decision to turn your business into a franchise or to potentially become a franchisee involves a great amount of research on both sides. For potential franchisors, the decision is based on whether or not relinquishing some profits to franchisees is a fair trade for the ability to quickly expand their business. The ability to

expand both nationally and internationally with little startup capital is usually enough incentive to drive a business into franchising. However, they must prepare all the necessary materials and legal documents before entering a franchise relationship in order for it to be a success, otherwise some franchises can fail and negatively affect the entire company. Simply because a company is a franchise does not guarantee success; if the business model is not fit for longevity or if the product is not competitive the entire company can still ultimately fail. Likewise, potential franchisees must consider their initial investment into a franchise and how it will pay off in the long run. They should research what companies are valuable franchises and how the franchisor/ franchisee relationship will benefit the franchisee in terms of marketing, training, and service manuals. A company with a positive public image and a business model that is going to hold up in the long run is the most valuable franchise option for a potential franchisee.

In my opinion, the potential profits that can be received from a franchisee outweigh the cost of starting up with the initial franchise fees. An independent business faces many challenges and stiff competition from large corporations and it can be extremely difficult to make a meaningful profit independently. The backing of a large corporation with marketing experts and product development experts can be vital to the success of an entrepreneur looking to start a business. The ability to go into business “for yourself, not by yourself” (International Franchise Association) is an intangible value of entering a franchise relationship. The franchisor will provide all the necessary materials to aid in your success, and when all franchisees are performing correctly the payoff is immense for all parties.

In regards to becoming a franchisor, I believe it is extremely successful if you have the means to do so. In order to franchise a business, the original business must have extremely solid ground to build upon. This way, it will stand up among other competitors, survive many different variables, and be a success in all locations worldwide. The product or service must be extremely competitive in order to join the other franchised companies. The newly franchised business must be able to compete against the McDonald's and the Marriotts of the hospitality franchise world, not only in the eyes of consumers but in the eyes of potential franchisees because you can not be a franchisor if no one wishes to buy a franchise. The decision to franchise can take years but if it is successful, the payoff is well worth it to become a household brand that consumers know and trust.

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