The Impact of the Internet on Franchising: What the Future Holds

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Some twenty (20) years ago, while making a presentation on "The State of Franchising", I communicated that I believed that the internet, then in its infancy, would have a profound impact on both retail franchising, generally, and on shopping center development and the real estate market, as well. That prediction has proved to be accurate.

Today, many products and even services, previously purchased or obtained in retail "brick and mortar" locations, can now be acquired "online". Folks who had travelled to their local (or not so local) "widget shop", can now acquire their widgets with the stroke of a finger, "online". Many customers, or prospective customers, have traded the personal service, attention and the "touch and feel" shopping experience, for the convenience and time saving aspects of shopping and purchasing by means of the internet.

Of course, since retail success is driven by customers, anything that reduces "traffic" will almost surely have a negative impact on the likelihood of retail success. Clearly, the internet reduces traffic at the retail level. Not coincidentally, as customer traffic has been reduced and retail sales have fallen, stores have failed. Many of these failing stores have been, and will likely continue to be, franchised retail locations.

A recent study by Aaron Smith and Monica Anderson point out that notwithstanding the fact that, all things being equal, two-thirds of online shoppers generally prefer store shopping to online shopping, still by 2015, approximately ten (10%) percent of annual retail purchases, almost $350 billion, were purchased online. Almost eighty (80%) percent of Americans make purchases via the internet. This trend is certain to continue to have a negative impact on retail purchases generally, and on franchised retail outlets inevitably. The New York Times recently reported (August 24, 2017) that storefronts in SoHo, one of Manhattan's retail hubs, and where, as recently as 2014, the annual rental cost for a 5,000 square foot storefront averaged $860, or $4,300,000, sit vacant. Why, because retailers (not only in SoHo, but across the country) have been "wounded" by competition from internet sales sites. A report issued by Credit Suisse on May 31, 2017 predicts that between twenty (20%) percent and twenty five (25%) percent of shopping malls in the United States, some 275 shopping centers, will close within the next five (5) years. This staggering (potential) occurrence could have a cataclysmic effect on franchising at the retail level.

Irrespective of whether or not this prediction proves to be accurate, its psychological impact alone is certain to effect both retail franchising and the real estate industry. Anticipating a downturn in the real estate market place, it is likely that real estate developers will be less prepared to commit the resources necessary to develop shopping centers than they have been in the past.

Lenders may be reluctant to commit funds to projects that, in the past, they had fought over, or if they do lend, interest rates may increase and loan to equity ratios will become less favorable for developers. Tenants will become more conservative in committing to costly locations calling for exorbitant rents. Rents, therefore, will fall. All of these factors will, inevitably, have an impact on retail franchising, which will, of course, include the enthusiasm with which prospective franchisees view the franchise opportunities available to them.

Does the proliferation of online purchasing spell the death knell for franchising? Not likely. But…it may call for some modification to the typical franchise model. Even before the advent of the internet, I contended, on behalf of franchisee clients, that it would be reasonable for them to receive some participation in revenues generated by the franchisor from the sale of the products sold by the franchisor in retail outlets,(supermarkets for example), within the franchisee's "protected territory". It had always seemed reasonable to me that if the franchisee's prospective customers were making purchases (of products sold by the franchisee) in venues other than the franchisee's retail location, and if the franchisor was receiving a primary benefit (e.g. the price received by the franchisor for the sale of the product to the supermarket) then the franchisee should receive some portion of that benefit. Over time, I extended my argument to include internet sales.

Most franchise agreements, then and now, have a "carve out" which gives the franchisor the right to sell its goods (or services, where applicable) at certain types of venues within the franchisee's territory. Today, franchise agreements almost universally include the "internet" within that carve out. The reasons for franchisors to allow their franchisees to participate in the revenues generated by such sales either to retail outlets located within the franchisee's protected territory, or to online customers located within the territory, are twofold. First, it is reasonable, but second, it is becoming necessary for the franchisee's economic survival. If the retail franchise model requires support to survive, and if internet sales are the culprit, why not make internet sales a part of the solution to the problem? Why not provide the franchisee with a participation in the revenue generated as a result of internet sales by the franchisor of products or services (ordinarily sold or provided by a franchisee) to customers located (residing or working) within the franchisee's protected territory?

The theory behind this approach is, of course, the fact that the internet has become, in significant part, responsible for a reduction in the revenues generated by the franchisee's retail location. This may vary from system to system and product to product, but the trend seems clear. If internet sales, are the culprit, it can be part of the solution. After taking into account factors which would include the nature of the products, price points, profit margins, etc., for both the franchisor and the franchisee, a relatively small percentage of gross online sales revenues could be paid (or perhaps credited) to the franchisee. "Gross sales" in this context, is far more practical than "net profits" in that it is easily determined and involves no complex calculations or formulas. In an ideal world, the formula would take into account the profit that the franchisee would have generated in its retail store from the "lost sale", as well as the fact that the franchisee would incur virtually no overhead expenses with respect to the income received.

Intrinsic in the fairness and reasonability of this approach, is that the franchisee's participation should be in revenues that might have been generated by its retail location rather than via the internet. Therefore an approach might be that the customer purchasing the franchisor's products online, would reside or work within the franchisee's protected territory. Since the franchisor would be in possession of (or have access to) the billing and shipping data with respect the online purchase, this determination should be relatively easy to accomplish.

Of course, franchise agreements would need to address the rights of the parties to have access to applicable information, perhaps by having the franchisor, for example, provide sales and customer location information to the franchisee, along with the applicable monetary calculations. How this information can be confirmed and/or reviewed would, inevitably, be subject to the usual challenges and negotiations.

While the above proposed arrangement between the franchisor and the franchisee addresses the means by which (and the likelihood of how) the franchisee can survive the encroachment upon its sales due to online purchases, it does not address the issue of how real estate developers, generally, can keep customers in their malls and shopping centers, or lure them back. While we may recognize that the type of purchase is likely to have a meaningful impact on whether or not a customer will purchase at home, online (e.g. the purchase of a book) or in a store (the purchase of a wedding dress) it will be necessary, in any event, for real estate developers to enhance the overall "mall experience" so as to bring more customers to malls and shopping centers. It is probable that the "mall experience", which is already changing, will continue to evolve. What we are seeing, and what we will continue to see, is a more interactive shopping environment for retail customers. The traditional emphasis on retail shopping may give way to more participation activities, both for individuals and for families. Sports activities may play a greater part on what is offered, along with entertainment venues and restaurants that offer a different level of "dining experience" then what is frequently found at malls and shopping centers. Of course, as the retail mix changes, this will effect franchising as well. Many of the new venues and activities will inevitably become franchises.

And now, in what may be the ultimate irony, online retailers have discovered that a "brick and mortar" presence may actually enhance their market visibility and are opening retail outlets in malls and shopping centers. A growing number of ecommerce sellers have developed "web rooms" containing large TV screens on their walls, where social media posts from satisfied customers are frequently displayed. Online catalogues can be accessed from tablets located throughout the retail location and orders can be placed. Online retailers recognize that a physical presence improves brand awareness, but they also recognize the cost savings and other efficiencies resulting from utilizing ecommerce. Of course, I'm waiting to see the first "online, web-based retail store franchise", which is certain to come.

As a result, while these changes may help the malls and the franchised retail locations they contain, to survive, other changes are also likely. The explosive growth that malls and shopping centers have experienced since the 1950's will almost certainly come to a halt. Yet, entrepreneurs, being who they are, will surely find ways to continue to develop. Malls and shopping centers may become smaller, in order to accommodate greater risk and the realities of the market place. Rents may have to come down so as to induce retailers to make the long term commitments that both landlords and lenders will both desire and require. All of this will have an impact on franchisors and franchisees. The one thing that is certain is that there will be change.

Who knows, we may even witness the reappearance of the small town, main street retailer. As for me, I hope so.