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Could You Franchise Your Startup?

Peter Birkeland
John Francis (Next Level Franchise)

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Franchising can be an alternative to private equity or self-financing to help companies scale, and a win-win for both franchisors and franchisees if done right.

If you're a startup thinking about funding your business, you're probably thinking about seed or venture capital Or, if you have paying customers, maybe you'll be able to grow organically. There is another choice we're betting most startup teams have never really considered: franchising. While nearly everybody knows something about franchising, to be successful at it requires understanding its unique subtleties and nuances. With that knowledge it might be a model that startups in other spaces can use to scale, allowing founders to keep control and avoid dilution. To help you decide if franchising might work for you, we'll provide a quick primer and suggest scenarios where it makes sense and a litmus test to see if it's right for your business.

Our work over decades in franchising involves research, consulting, and operations. We've seen and experienced the good, bad, and the ugly, and we can definitely say that with the right approach and mindset, franchising can be a win-win-win for franchisors, franchisees, and customers. With the wrong approach and mindset, a company might limp along for years with a handful of franchisees and no market penetration.

What is franchising, really?

Most people have bought something at a franchise. After all, there are over 4,000 different franchise systems in the US. But, if you searched the internet for a definition of franchising, you're likely to find variations around themes of business model, licensing, and fees. For example:

- **AI-Generated:** Franchising is a business model where a franchisor allows an independent business owner, known as a franchisee, to operate a business using the franchisor's brand, business model, and proprietary knowledge in exchange for fees and royalties.
- **Investopia:** A franchise is a business whereby the owner licenses its operations—along with its products, branding, and knowledge—in exchange for a franchise fee.
- **Market Business News**: Franchising is an arrangement in which the franchisor gives the franchisee the right to distribute and sell its goods or services and use its business name and model.

Our own definition is that franchising is a way of licensing your intellectual property. It's a way to raise capital and keep control of your company instead of using private equity or private financing. The key point is that you actually have something proprietary: intellectual property tied up in your products, systems, brand, or trademark that is valuable enough that somebody will pay you money to run a replica of your business.

Not every franchisor has valuable intellectual property that they are licensing; many are selling commodities in an undifferentiated way. That's why a third of all franchise systems in the US have fewer than 5 units and half have fewer than 20 units. Those franchisors have a me-too product and an unknown brand. For example, a business owner wanted to franchise their car wash business but there was nothing proprietary about it. They didn't have a unique process and there was no IP around soaps or detergents. There was nothing of value that would compel any potential franchisee to want that franchise. If that owner had IP around a 10-second car wash, for example, that would be game-changing, but they didn't have that and instead had little value to offer prospective franchisees.

While some businesses should never be franchised, there are others that should be franchised. For example, we think distributorships and consulting firms are good candidates for franchising, but we will save that for another article.

Is Franchising Right for Your Business?

Before we get into the mechanics of how franchising works, it's helpful to understand if franchising is right for your business. Do you and your leadership team have the right mindset to pursue and thrive as a franchisor? Here are several things to think about.

Locked-in business model. The most obvious elements of franchising are the consistency and predictability of products and services, including standards around nearly every operational and aesthetic aspect of a business. Customers of franchised products or services ought to experience a sameness regardless of location. Think McDonald's, Jiffy Lube, or Dunkin' Donuts, for example. Those same qualities of consistency and predictability also translate into trainability and repeatability, which allows a franchisor and their franchisees to scale quickly.

If you're still figuring out product-market fit, or have thoughts about pivoting, franchising won't be an option for you. It's not "no," never, but "no," not now. You'll need to wait until you have a history of proven success before you can even contemplate franchising.

Value proposition. While every company has a value proposition (explicitly stated or not), in a franchise a strong value proposition answers the question, *"Why should I invest in your brand instead of any other?"* If you're asking franchisees to finance hundreds of thousands or millions of dollars, you had better be clear on your value proposition. The best franchises have value propositions that are:

- Clear, differentiated, and protected trademarks (always) and patents (sometimes)
- Evidence-Based, proven in multiple instances and markets
- Targeted, focused on specific customers or segments of the market / industry
- Consistent and scalable with support and careful innovation

A franchise value proposition is not a consumer tagline, or a generic, one-size-fits-all static document you put together and forget. It is a dynamic, thoughtful expression that should evolve with your brand and the market.[1]

Entrepreneurial culture. Franchises, whether they have 5 units or 30,000 units, are managed like a startup, with lean operations and low overhead. Franchisors reject layers of middle management, hundreds of job titles, and significant Selling, General, and Administrative expenses, and instead spend resources on product development, marketing, and franchise sales.

Embracing an entrepreneurial culture also means that leaders manage differently, with less direction on how franchisees manage their units. It's up to the franchisee how to run their P&L, set their salary and expenses, create the culture they want, and build out their growth strategy. Command and control might work for some organizations but in a franchise system it's an ineffective leadership style.

For example, a brand can fail miserably if leaders dictate or lead with a heavy hand. Quiznos is a well-known example of that. The franchisor required franchisees to buy nearly all of their products and materials through Quiznos's controlled supply and distribution systems. Franchisees had very little margin to operate and no matter how good they were, they couldn't make any money or scale to multiple units. Quiznos made an enormous amount of money. By the time franchisees figured out what was going on and sued, the system collapsed and failed. It was tragic.

Community over isolation. Franchise systems have flat organizational structures with fairly clear boundaries between franchisees in any location. That means that franchisees are not competing for customers with each other and they are more likely to share best practices, provide guidance to others, help other franchisees, and share their opinions on what can be improved. One of the biggest benefits for both franchisees and franchisors is the strong community that develops among everybody in a system.

For example, Sport Clips created an internal Memorial Relief Fund where every franchisee chips in $10 per week into a separate fund, managed by an independent third-party. When people in the brand are suffering from some type of loss or catastrophe, they apply to receive a

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financial boost to get through that situation. Perhaps it is income to them, or to a manager or stylist. Besides being a compassionate program, it also creates unbridled loyalty, motivation, and connectivity, leading to better recruiting and retention of staff.

Local knowledge. How important is it to your business to have an actual person working closely with customers? How important is local knowledge? Even in the US there are regional variations that matter, and a franchisee with deep knowledge of the community and strong connections within an area will be more likely to succeed. Of course, local knowledge is even more important for international locations, and a franchisee with the language and culture skills will be far superior to exporting an American, for example, to Brazil.

Tap other sources of capital to expand. Unlike startups seeking venture capital or venture debt, or corporations seeking bank loans or other financial instruments to expand, franchisors use other people's money to expand. If a franchisee wants to buy a franchise license, they need to figure out where to get the money. Maybe it's out of their savings, or an SBA loan, a second mortgage on their home, or even an inheritance. Franchisors don't have to create a deck for venture capitalists and don't give up equity to expand but can instead rely on self-funded franchisees to grow.

Getting Started

Franchising is an alternative way to scale that doesn't rely on funding from venture capital, private equity, or customers. At the most basic level, franchising is a contractual agreement where the franchisor licenses its intellectual property to franchisees. It allows franchisors to control their product quality, make product innovations, and to focus on marketing and their expansion strategy (locations, franchisee qualifications, etc.). This frees up franchisors to focus on helping franchisees be successful.

The reverse is true for franchisees: they don't have to worry about products and product innovation, marketing beyond their local area, or scaling. Franchisees can focus all their efforts on local operational excellence, creating an environment where individual contributors and managers can thrive, and focus on growing their local market.

To sell a franchise anywhere in the US you will need to register annually with the FTC (https://www.ftc.gov/business-guidance/resources/franchise-rule-compliance-guide) and complete a Franchise Disclosure Document (FDD). That's a detailed, 23-item list of requirements for franchisors. There are also 15 US states that have state-specific requirements, so there are hurdles to overcome before becoming and continuing to be a franchisor.

But, if you have valuable IP, if you want to keep the lean and entrepreneurial culture of a startup, and if you want to scale without dilution, franchising might be right for you. Franchising is Portfolio Theory in practice, but rather than investing in multiple different companies hoping that you can get above-average returns, you can invest in scaling your own company and achieve the same thing: high returns across a portfolio of franchisees. Private equity figured this out 10-15 years ago, and today there are many PE firms investing in both franchise systems and multi-unit franchisees.

Franchising isn't for every business, but for the entrepreneurs who want to keep an entrepreneurial culture and avoid dilution as they scale, it is a model that many startups should consider.

[1] For more context on franchise value proposition, see Joe Caruso's LinkedIn post here: https://www.linkedin.com/pulse/franchise-value-proposition-what-isnt-why-its-critical-joe-caruso-p89ce/?trackingId=4ANhiBTcdokMVSQFgOabUA%3D%3D

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