INTERNATIONAL FRANCHISE ASSOCIATION

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NEIGHBORLY

TESTIMONY BEFORE THE HOUSE SMALL BUSINESS SUBCOMMITTEE ON OVERSIGHT, INVESTIGATIONS, AND REGULATIONS

HEARING ON "*NAVIGATING REGULATIONS: ALTERNATIVE PATHWAYS TO INVESTING IN SMALL BUSINESSES*"

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Good morning, Chairwoman Van Duyne, Ranking Member Mfume and distinguished members of the Committee. My name is Mary Kennedy Thompson and I am the Chief Operating Officer of Neighborly, a family of home services companies, with more than 5,800 franchises serving more than 12 million customers in six countries. We specialize in repairing, maintaining and enhancing homes and properties worldwide.

It's an honor to be here today to give my perspective on the impact alternative areas of financing can have on small businesses, especially franchisors, franchisees, and their employees.

I appear today on behalf of the International Franchise Association (IFA), the world's oldest and largest organization representing franchising worldwide. IFA works through its government relations and public policy, media relations, and educational programs to protect, enhance and promote franchising and the approximately 806,270 franchise establishments that support nearly 8.7 million direct jobs, $858.5 billion of economic output for the U.S. economy, representing almost 3 percent of the Gross Domestic Product (GDP). IFA members include franchise companies in more than 300 different business format categories, individual franchisees, and supplier companies that support the industry.

Today, I will tell you more about Neighborly and franchising generally, and also share how some of the ways nontraditional financing, such as via private equity, can help companies grow their brands and companies faster and smarter. I believe franchising is the greatest democratization of wealth creation that exists today.

The unique franchise business format

Franchising is perhaps the most important business growth strategy in American history. The first franchises started in the colonies by Ben Franklin, and over the centuries, this system has served as a core American model of opportunity and entrepreneurism. In 1731, Ben Franklin entered into a partnership with Thomas Whitemarsh, who franchised his printing business – *The Pennsylvania Gazette*. Later, Whitemarsh would introduce the first "franchised" newspaper of South Carolina, the *South Carolina Gazette*.

Franchising has contributed to robust job creation and provided foundational skills development for small business owners and their workers. Today, there are more than 800,000 franchise establishments, which support nearly 8.4 million jobs.[1] Many people, when they think of franchising, focus first on the law. While the law is certainly important, it is not the central thing to understand about franchising. At its core, franchising is about the relationship the franchisor has with its franchisees—how the franchisor supports its franchisees, the franchisor's brand value and how the franchisee meets its obligations to deliver the products and services to the customers using the system's brand standards.

The value of franchising is supported by empirical data. A recent study by Oxford Economics found that franchising offers a path to entrepreneurship to all Americans, but especially to minorities and women. Around 26% of franchises are owned by people of color, compared with 17% of independent businesses generally. In addition, franchising offers the opportunity for business ownership that would not otherwise be available, especially to women, people of color, and veterans.[2] Franchises businesses also perform better and provide better pay and benefits than

[1] Franchiseeconomy.com (2021).
[2] The Value of Franchising. Oxford Economics (2021)

their non-franchised counterparts. On average, franchises report sales 1.8 times as large and provide 2.3 times as many jobs as non-franchise businesses. Sales and jobs in franchised businesses exceed non-franchised businesses across all demographic cuts, including gender and race. For example, Black-owned franchise firms generate 2.2 times as much in sales compared to Black-owned non-franchise businesses, on average.

Despite how it is often characterized, franchising is not an industry. Franchising is a business growth model used *within* nearly every industry. More than 300 different sectors are represented in franchising, and franchise companies offer a huge range of products and services from lodging to fitness, home services to health care, plumbing, pest control, restaurants, security, and lawn care.

Further, despite popular misconceptions, franchising consists of far more than merely the "fast food" industry. In fact, 63% of companies that franchise are not in the food services at all, and 83% are not in fast food.[3]

There are two principal explanations given for the popularity of franchising as a method of distribution. One is that it "was developed in response to the massive amounts of capital required to establish and operate a national or international network of uniform product or service vendors, as demanded by an increasingly mobile consuming public."[4] The other is that franchising is usually undertaken in situations where the franchisee is physically removed from the franchisor, giving autonomy to the franchisee to run their own day-to-day business operations. These two motivations are consistent with a business model in which the licensing and protection of the trademark rests with the franchisor, and the capital investment and direct management of day-to-day operations of each franchise unit are the responsibility of the franchisee who owns, and receives the net profits from, its individually owned franchise unit.

It is typical in franchising that a franchisor will license, among other things, the use of its name, its products or services, and its operational processes and systems to its franchisees. The turnkey nature of operating a franchised business is why I and so many of my fellow franchisees purchased a franchise. Franchisees look to the franchisor to protect the trade names, trademarks and service marks (collectively the "Marks") and brand by establishing and enforcing standards on all franchisees in a system. Such standards are essential for protection of franchisees' equity in their businesses and consumers of the brand. These standards allow franchisors to maintain the uniformity and quality of product and service offerings and, in doing so, to protect their Marks, the goodwill associated with those Marks, and most importantly, consumer confidence in the Marks and brand. Because a core principle of franchising is the collective use by franchisees and franchisors of Marks that represent the source and quality of their goods and services to the consuming public, action taken to control the uniformity and quality of product and service offerings under those Marks is not merely an essential element of franchising, it is an explicit requirement of federal trademark law under the Lanham Act.

My Franchise Business Story

I have spent more than three decades in franchising, both as a franchisee and a franchisor. Before my career in franchising began, I served for eight years as an officer in the US Marine Corps, including as the first female platoon commander for my unit. When I returned home to Texas after

[3] FRANdata research. (2021).

[4] Kevin M. Shelley & Susan H. Morton, "Control" in Franchising and the Common Law, 19 Fran. L. J. 119, 121 (1999-2000)

my time serving in the Marine Corps, I wanted to own my own business, take control of my destiny, but I had no business experience and knew I needed help if I were to make that dream come true.

In 1994, I got my start as a franchisee in the Cookies by Design system and have grown in franchising ever since. The franchise model empowered me, someone with no business experience, to start my own business with the guidance, resources, and assistance I needed to be successful. After selling by locations, I went to work at the franchise headquarters and went on to become President of Cookies by Design. After being recruited to the Dwyer Group, now re-branded as Neighborly, I served for nine years as President of the Mr. Rooter brand within the group and also as the Vice President for International Relations.

I'm here today as the COO of Neighborly, which began in 1981 with just one brand and is now the holding company for 30 home service-based franchise organizations in the United States.

In my role with Neighborly, I help new franchisees under our brands achieve their business-owning dreams—just as I did more than 30 years ago. Our mission is to teach our principles and systems of personal and business success so that all people we touch live happier, more successful lives. I do this by presenting and teaching the franchise system, including how to best run a business, take care of customers, serve the community, and create jobs. We don't employ, hire, or fire our franchisee's employees. It is not the role of a franchisor to get between a franchisee and their employees. Rather, our role is to share with franchisees our knowledge and experience to ensure that our franchisees are doing the best possible job running their franchise to protect our brands.

Neighborly specifically operates with the core values of respect, integrity, and customer-first. As a veteran, I'm incredibly proud of our work for veterans. Neighborly is the founding company of the Veterans Transition Franchise Initiative, or VetFran. VetFran is an effort by more than 500 IFA member companies to encourage franchise ownership by offering financial incentives to honorably discharged veterans. The VetFran program has led to countless veterans becoming franchise business owners since the initiative was launched in 1991. To date, Neighborly has brought in more than 750 veterans to become business owners receiving more than $5 million in discounts on their franchise fees.

Franchising is an interdependent relationship in which the franchisor licenses to the franchisee the right to use its trademarks, intellectual property, and business and operating plans in exchange for a fee. Through this system, both parties win. The franchisor can expand more effectively than through corporate ownership, and the franchisee is able to be his or her own boss while using a proven operating system. We like to say that franchising allows you to be in business for yourself, but not by yourself.

The system works through mutual dependence that requires close collaboration between the franchisor and franchisee. I've been on both sides of the relationship, and I can tell you that communication and trust are critical for success. We provide resources to help our franchises address some of their most pressing challenges. Recruiting and hiring good people, for example, is an enormous challenge for franchisees, many of which are small, with fewer than 10 employees. Franchisors like ours have historically been able to provide assistance in identifying good people and helping effectively train those workers. Franchisees get the valuable experience of running their own business, while having the franchisor's assistance to provide the resources and support they need.

SBA Lending

The Small Business Administration (SBA) and its lending programs and the access to capital they provide are a big part of the franchise success story. About 20% of SBA lending goes to franchising. In 2022, about 7,000 loans were approved in the 7(a) and 504 programs representing more than $5 billion of loan volume and supporting more than 100,000 jobs.

Last year, the SBA finalized a number of changes to its affiliation rules, including elimination of the concept of affiliation by control, which also resulted in elimination of the Franchise Directory.

The IFA supports efforts to streamline government-supported lending programs and recognizes this was the intent of eliminating the principle of affiliation by control in the SBA size standards, which in the case of a franchise is currently based on franchise agreements. Those determinations required, by their very nature, subjective assessments of contract language. As such, consistency of those determinations, delays in approvals created by occasionally lengthy reviews, and the back and forth with franchisors to reach acceptable agreement language all were impediments to franchisees being able to access the capital they needed to grow. We commend the SBA's desire to address these issues and believe this is a good effort to do so.

However, as part of the affiliation review and use of the Franchise Directory, the SBA conducted an eligibility review, an effort to help lenders from an efficiency standpoint. Unlike other businesses, in franchising there is a set of agreements between a franchisor and the small business franchisees that borrow using SBA-guaranteed loans. In essence, it is a one-to-many review. One-time eligibility review decisions eliminate the need for each lender to review the sometimes lengthy and complicated agreements to assess eligibility. Importantly for franchisors, such reviews avoided the problem encountered years ago where they got inconsistent and often conflicting decisions and requirements from various lenders.

IFA's understanding of the affiliation change now shifts this burden to lenders. This shift may create an inefficiency that will put many franchise brands at a disadvantage. IFA is particularly concerned about access to capital for emerging brands (of which there are hundreds each year) and smaller, regional brands. Will a community bank be willing to make a loan to a franchisee associated with a brand that requires the banker to wade through multiple franchise documents to determine eligibility? Most franchise loans are relatively small, averaging under $400,000. The economics for lenders doing only one or a few franchise loans may drive them away from franchise lending completely.

We appreciate the Committee's attention to this issue given how critical SBA lending is to new franchisees. Banks and borrowers are still adapting to these changes. We are closely monitoring marketplace realities and look forward to continued dialogue with you on this.

Alternate Forms of Capital to Help Franchise Businesses Grow

As I shared earlier, I'm no shill for private equity, I am a Marine. But I have lived the American Dream of being an entrepreneur and helping grow and scale businesses. This would not be possible without alternative forms of capital.

Private equity has been a catalyst for growth for me and many of Neighborly's franchise owners. In years past, small business owners like me when I was a franchisee could depend on their local bankers and community banks to be a willing partner, providing capital at reasonable interest rates and an ally throughout the many steps of growing a business. But in the era of bank consolidation and mega-mergers, this breed of banker has faded away. And they are less concerned with growing their neighborhood Glass Doctor.

Furthermore, many of our franchise owners don't speak the language of high finance; they're small business owners, many without a college degree. There is a divide in the business world between the elite and these small business owners who are part of their small and mid-size communities. The small business owners may not know where to start to get financing to grow their business or might not be able to secure favorable rates. But this is where private equity has become an asset to our franchise owners.

Private equity acts as a thought partner for our franchise owners – they often have real-world business experience and then can apply this knowledge to help our partners grow. Small private equity shops make their living by identifying under-utilized businesses and helping them develop. They can serve as a sounding board on best practices and practical growth strategies. They offer strategic advice on how to set long-term goals and navigate industry trends. Their experience across various sectors can help franchise owners make informed decisions and stay ahead of the curve. They help our franchise owners grow every step of the way.

Additionally, private equity can serve as an effective liaison to the banks and other investors. They give our franchise owners instant credibility and connections. As we've established, there can be a language divide between small business owners and modern bankers. Private equity shops can serve as translators for our owners, connecting those with capital to those who need it.

Private equity networks extend beyond financial backing. They open doors to our franchise owners and help connect them to potential clients, suppliers, and other businesses within their portfolio. These relationships can super charge growth in terms of new partnerships, joint ventures, and new market opportunities.

Their network helps attract top talent as well. As private equity grows our franchises, they can assist in recruiting key executives and building strong leadership teams as the franchise owner scales their business.

One story I'd like to share with the Committee – Neighborly has a franchise owner near Atlanta in a growing market. He was ready to retire and, in our world, your three options are to 1) pass along the business to your children 2) close it down or 3) sell the business.

Now, as I'm sure many of you know, many children want to chart their own path and pursue different career opportunities. Only roughly 20 percent of our businesses get passed down. As for the second option, nobody wins when a business closes down, not the franchise owner, nor the community.

That leaves the option of selling. In this case, private equity was able to step in, navigate a sales process that helped our franchise owner exit the business with a tidy profit but then help the purchaser focus on growth. In only two years, the new purchaser doubled the size of the business, fueled by the access to capital provided by their private equity partner.

Now private equity, nor additional working capital, isn't a silver bullet. I tell all my franchise owners that they need a strong foundation and a vision for the future to maximize what private equity can do for their business. But when a franchise owner gets the right thought partner, private equity can be the rocket fuel that takes their business into the stratosphere. And with that growth comes increased jobs in their communities.

Policies hindering the growth of small business ownership

One headwind is a particular aspect of tax policy – the limitation on the deductibility of interest imposed by the Tax Cuts and Jobs Act. Prior to January 1, 2022, businesses' interest expense deductions were limited by section 163(j) to 30% of their earnings before interest, tax, depreciation, and amortization (EBITDA). Interest deductions are now limited to 30% of earnings before interest and tax (EBIT) – a stricter limitation. This change, combined with rising interest rates, is proving to make incremental investments by small businesses much more expensive.

On average, a business affected by the change could see a three-fold increase in its incremental tax burden, facing both higher interest rates when financing improvements and a very high tax rate.

Additionally, I would like to highlight an issue that has the potential to completely undermine the franchise business model. The National Labor Relations Board (NLRB) issued a final rule on a joint employer standard that would reverse its course back to the harmful 2015 version.

The NLRB's proposal largely reestablishes the broad Obama-era standard of joint employment, under which one company may be deemed the joint employer of a second company's employees not only where it directly or immediately exercises control over the second company's workforce, but where the first company's putative control is indirect, or even simply reserved but not ever actually exercised. This puts franchisors at risk of being sued for things they never did and had no power to stop. Moreover, it risks wiping away the equity that I have spent my life and career building in my businesses and ultimately makes me a middle manager of my brand. The joint employer standard created by the NLRB in 2015 led to a nearly doubling of litigation against franchise businesses, cost franchising $33 billion per year, and preventing the creation of 376,000 new jobs in the four ensuing years. Small businesses will not survive a similar consequence in the current labor market.

The NLRB's changes to the joint employer rule will take away the equity and independence of franchise small business owners and would put their success and livelihoods, including mine, in jeopardy. Franchisors will naturally move to hire numerous attorneys to oversee employment issues and claims across its network of independently owned franchised businesses over which the franchisor has no control. Ultimately, the additional costs to the franchisor would translate into additional costs to independent owners like me, and that would make the franchise business model untenable.

In fact, research released last week by Oxford Economics based on a July 2023 survey of franchisees shows that franchise owners are bracing for more harm from the new NLRB joint employer rule as it injects uncertainty in the franchisor-franchisee relationship and threatens standards enforcement across franchise systems. Overall, 43% of franchisee respondents expected a change in the franchisor/franchisee relationship as a consequence of the NLRB's joint employer rule, although there is uncertainty among franchisees regarding the responses from franchisors. Approximately 20% of respondents expected franchisors to increase control over their operations while another 20% expected franchisors to distance and reduce operations and compliance support.

Approximately 40% of franchisees did not know what to expect, and the remaining 20% expected no change. This uncertainty about franchisor responses to the new joint employer rule brings with it significant concern among franchisees, with 74% of franchisees expressed a high level of concern at the prospect of increased franchisor control, and 55% a high level of concern with reduced franchisor support.

The Oxford Economics report is also expected to identify increased costs for franchisees as a result of responses by franchisors to mitigate risk under the new joint employer rule. These include the heightened risk of litigation (i.e., 70% of franchisees expected increased litigation) and increases in legal and advisory fees, as well as higher insurance and operations costs. Meanwhile, the new rule may reduce the attractiveness to being a franchisee with respect to operating an independent business and lead to fewer franchises (i.e,, 66% of franchisee respondents expected the new standard to raise barriers to entry into franchising).

This report confirms that franchisees have significant concerns about their ability to do business if the NLRB moves forward with its proposed joint employer rule. A majority of franchisees are highly concerned about both increased franchisor control and decreased franchisor support, demonstrating that franchising currently has the right balance in the franchisor-franchisee relationship. Unnecessary, expanded joint employer liability will hurt franchised businesses – just as it did in 2015.

I urge Congress to reject this unnecessary and over-reaching rule via the Congressional Review Act.

Conclusion

Franchise businesses contribute significantly to our nation's economy, creating a diverse range of employment opportunities from entry-level positions to management roles. By offering these opportunities, franchises help address unemployment and underemployment, ensuring that individuals across our nation have access to stable, fulfilling work.

Moreover, franchised businesses often provide comprehensive education and support for their employees, fostering the development of a skilled workforce. These workforce development programs not only benefit individual businesses but also contribute to the overall strength of our nation's workforce, making it more competitive on the global stage.

Franchise businesses also offer unparalleled opportunities for people of color, women, and veteran entrepreneurs, promoting a more inclusive and diverse business landscape. This diversity strengthens our workforce and helps create a more equitable and prosperous society.

It is also important to acknowledge the role franchise businesses play in community engagement. Most franchises invest in their communities by engaging in charitable activities and supporting local organizations. This not only creates an environment where people can thrive but also contributes to a more robust workforce.

Madam Chair, Ranking Member Mfume, thank you again for holding this hearing and for the invitation to speak on behalf of small business owners everywhere. I look forward to answering any questions you may have.