FRANCHIZE CONSULTANTS

FRANCHISING CONFIDENCE INDEX

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FRANCHISING CONFIDENCE INDEX QUARTERLY SURVEY

Franchize Consultants' ***Franchising Confidence Index*** is a quarterly survey of 383 New Zealand franchisors and 115 specialist service providers (e.g. consultants, banks, accountants, lawyers and publishers) to the franchising community.

The Franchising Confidence Index represents confidence in key measures critical to the success of franchising in this country by reporting attitudes toward general business conditions, as well as key franchising growth determinants including access to capital, suitable potential franchisees, staff and locations. The Franchising Confidence Index also covers franchising health attributes and outcomes by exploring franchisee sales, operating costs and profitability, and franchise system growth prospects.

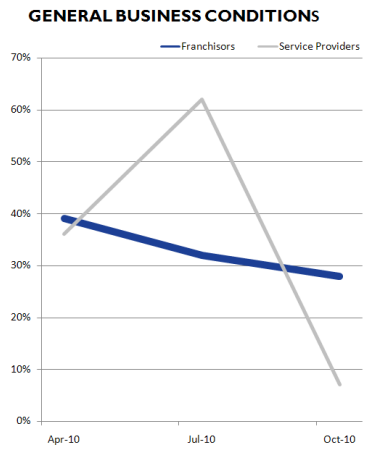
The data and analysis presented represents the views of 43 franchisors and 29 service providers collected between Monday 4 October and Friday 8 October 2010. Findings from both groups are reported separately.

Note, respondents are asked whether they expect conditions to be 'better,' 'same' or 'worse.' 'Net' confidence is the difference between those reporting 'better' and 'worse.'

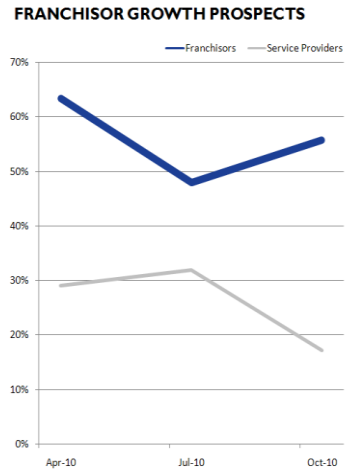
FRANCHISING CONFIDENCE SURVEY HIGHLIGHTS

FRANCHISING SENTIMENT SLIDES FURTHER. CAPITAL CONSTRAINTS AND FRANCHISEE CONCERNS REMAIN

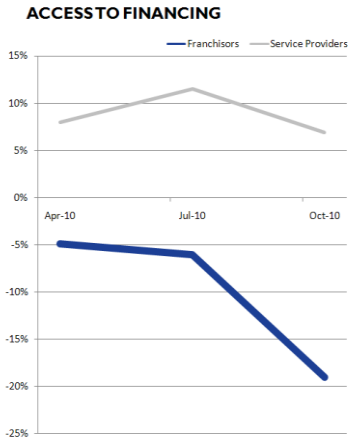
Franchize Consultants' October 2010 quarter Franchising Confidence Index finds positive but falling sentiment across many key franchising indicators, including general business conditions, access to financing, suitable franchisees and locations. Meanwhile, franchisee sales levels and operating costs, and franchisor growth prospects are forecast to improve, while availability of suitable staff and franchisee profitability levels are expected to remain unchanged.



Franchisors remain generally positive about forthcoming general business conditions (net 28%). This represents a gradual decline from April (net 39%) and July (net 32%), respectively. Overall, franchisor sentiment exceeds general business sentiment as measured by the BNZ Confidence Survey (net 18% in October), National Bank Business Outlook Survey (14% in September) and the NZIER (-9% in September). Meanwhile, service provider sentiment for general business conditions (for franchisors generally) plummeted to net 7%, from 62% in July.

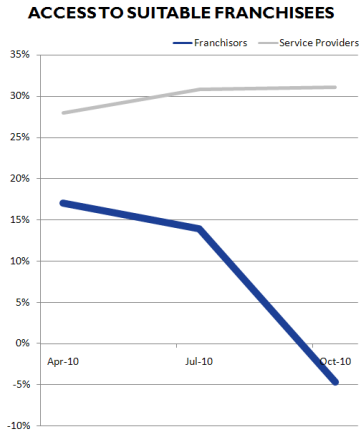


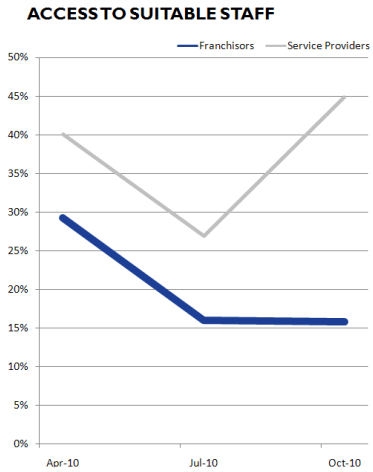
Franchisors are still generally positive about forthcoming growth prospects for their organisations (net 56%), compared with service providers perspective for franchisors generally (net 17%)**.**

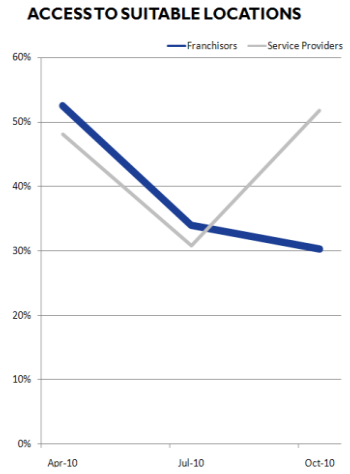


An increasing, and worrying, net -19% of franchisors expect access to financing to *deteriorate* over the coming year. This compares with -5% and -6% in April and July, respectively. Service providers are marginally more optimistic (net 7% positive) for franchisors generally. These findings demonstrate access to finance (a key growth constraint) continues to trouble development within the franchise sector.

Franchisors see tougher access to suitable franchisees in the year ahead (net -5%), down from 14% in July**. Meanwhile, perceived access to suitable staff holds at net 16%.** Comparatively, service providers see a more positive outlook for franchisee and staff recruitment with a net 31% and 45%, respectively.

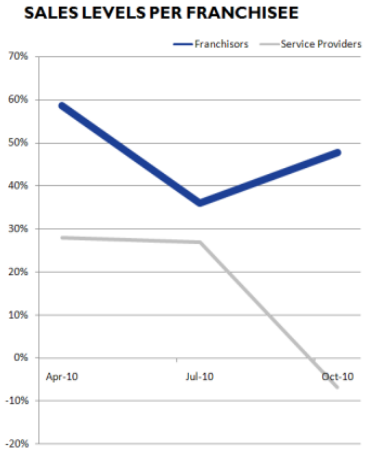


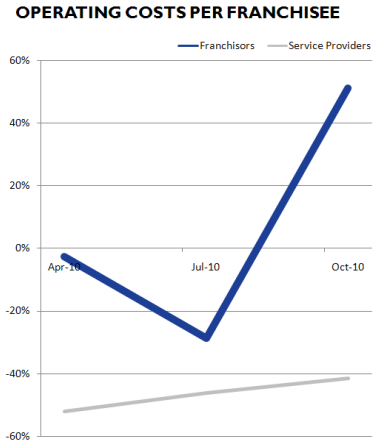


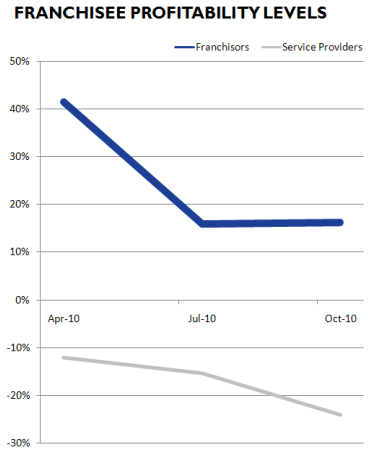


Franchisors (net 30%, down from 34% in July) and service providers (net 52%, up from 31% in July) share a generally positive outlook for finding good locations – where applicable.

Encouragingly, franchisor sentiment for franchisee sales levels climbed to net 48% (from 36% in July), and the outlook for operating costs improved dramatically – with a net 51% (compared to -29% in July) expecting improvements over the next 12 months. Meanwhile, a net 16% of franchisors expect franchisee profitability levels to be better (same as July, but down from 41% in April).







Comparatively, service providers were far less optimistic in their outlook for franchisees, generally. A net 7% (27% in July) expected deterioration in franchisees sales levels. 41% (compared to 46% in July) expected deterioration in operating costs. Finally, a net 24% expected franchisee profitability levels to deteriorate. **Overall, while franchisors expect improvements in sales and growth, both groups clearly see tough times ahead for franchisees generally.**

Franchisors were asked 'how things are looking in their sector,' and service providers 'how things are looking for franchisors and franchisees (generally).' Franchisor comments indicate huge variations in current and expected sales activity. Indeed comments range from "still very grim" to "solid and looking promising." On balance sales were challenging, but expected to improve – with some franchise systems more positive than others.

Clearly challenges exist within many sectors with competition driving margin erosion and some customers internalising tasks previously outsourced to franchise companies. A number of franchisors also note profit pressure due to rising inputs costs, rents and inflexible landlords.

Access to financing is also raised. Bank lending criteria has changed and one franchisor notes the development of alternative funding sources. Aligned levels of franchisee enquiries are slow, with few qualified enquiries cited, generally – however, two franchisors cited good, strong potential growth prospects.

Franchise service provider comments reflect the uncertain environment. Most note "uncertainty" and expect a slow recovery at best. Comments such as "[t]ougher work to make the same dollar" and "it will be a tough year ahead" show service providers expect challenging times for many franchisors and franchisees to continue.

Franchise challenges cited included tougher bank lending criteria, GST impact short-term (affecting required working capital), increasing struggling franchisees and royalty delinquency rates (i.e. franchisees not paying franchisor royalty income), difficulties maintaining confidence in the franchise system, and workplace competition for prospective franchisees.

On a more positive note, service providers note the potential for further interest in franchising from increased redundancy levels, examples of franchisees de-leveraging and favourable leases renegotiations.

Moving forward there is a recognised need for franchisors to review, streamline and improve their networks, and increase focus on franchisee profitability levels. Externally, it suggested the government provide more focused interest and SME support as per the USA and UK.

Dr Callum Floyd, Director of Franchize Consultants, who undertakes the survey, notes:

"The continued downward trend in sentiment and low levels of expectations for many key franchising variables is of considerable concern to franchisors and franchisees, and should concern the wider economy and government."

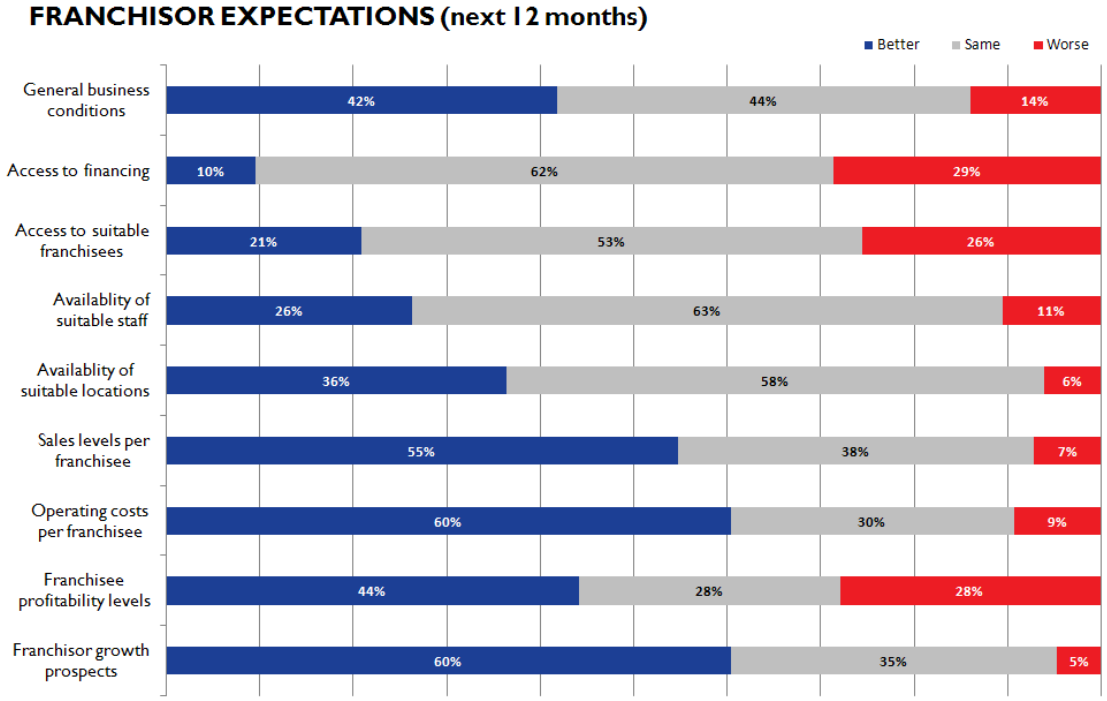
"Franchising is pervasive covering many important sectors of business from grocery to home services, and is a great contributor to job growth, business training, SME compliance (due to good business systems) and GDP. But it requires the right environment including, crucially, access to capital for expansion and confidence."

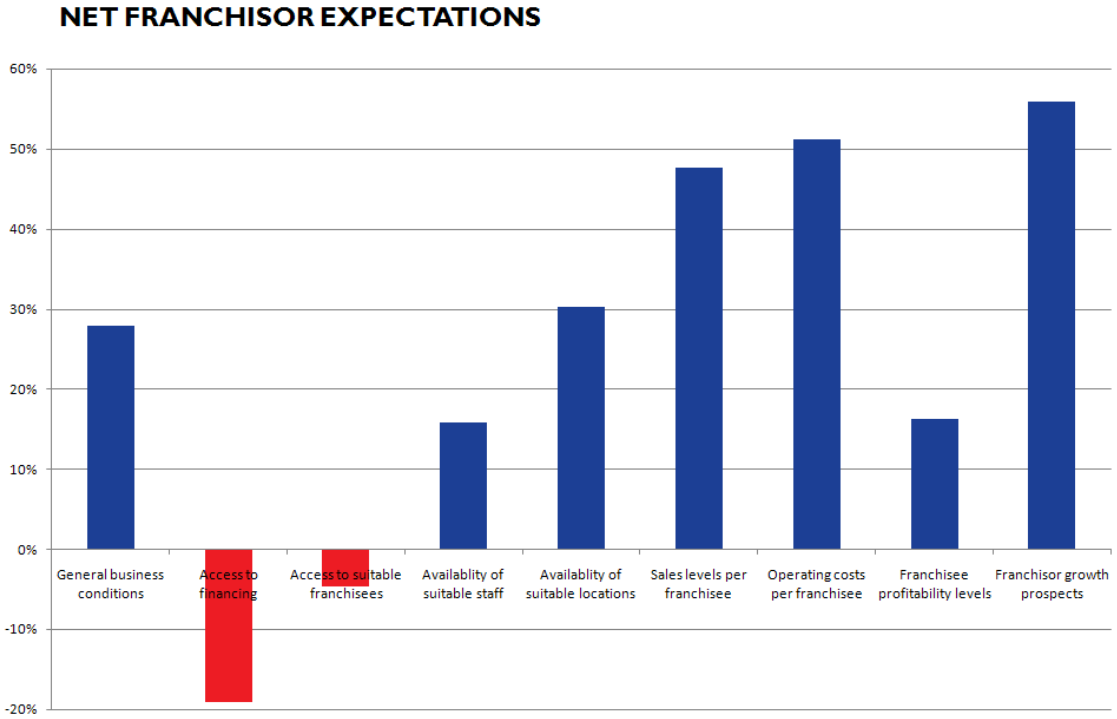
"Many well-known (and lesser-known) franchisors and franchisees have been hammered by the economy and continue to trade and battle despite considerable adversity. They do not crave handouts but they are desperate for an environment that fosters positive business growth and development."

"It's time government recognised franchising properly for its contribution, and needs."

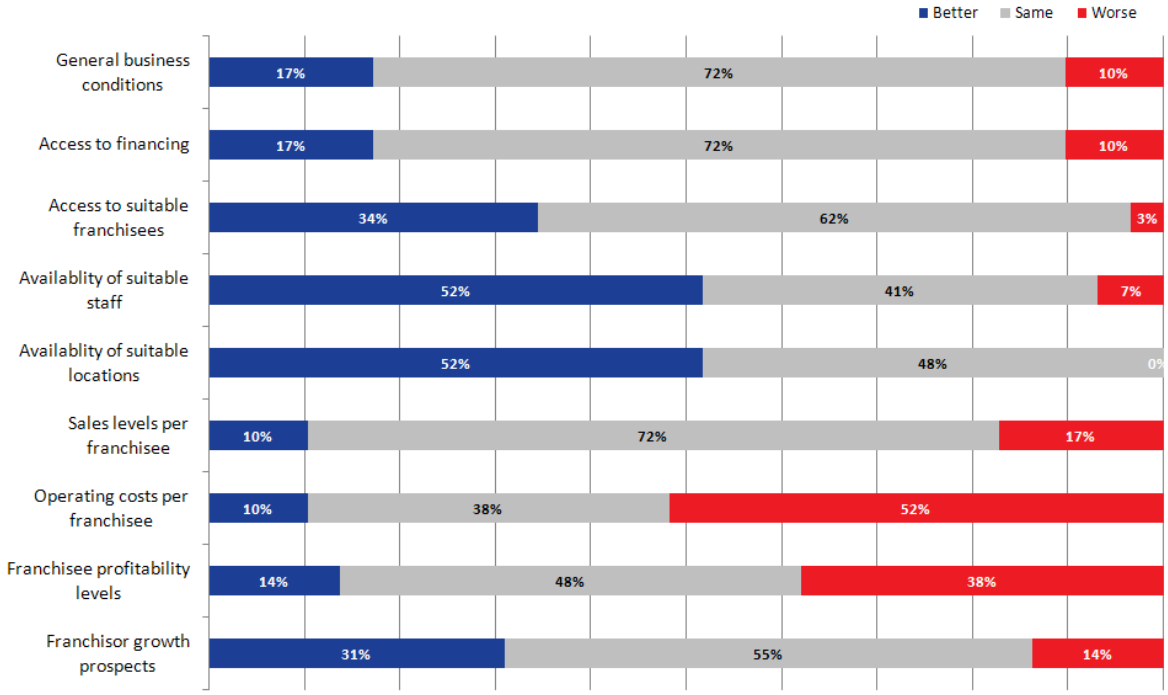
FRANCHISING CONFIDENCE CHARTS

Franchisors were asked whether they expect each aspect to be better, the same or worse in the next 12 months (compared to the previous 12 months). The following four illustrations present individual and net franchisor and service provider expectations (separate tables) for the following year across all questions, including general business conditions and franchisor growth prospects (covered above).

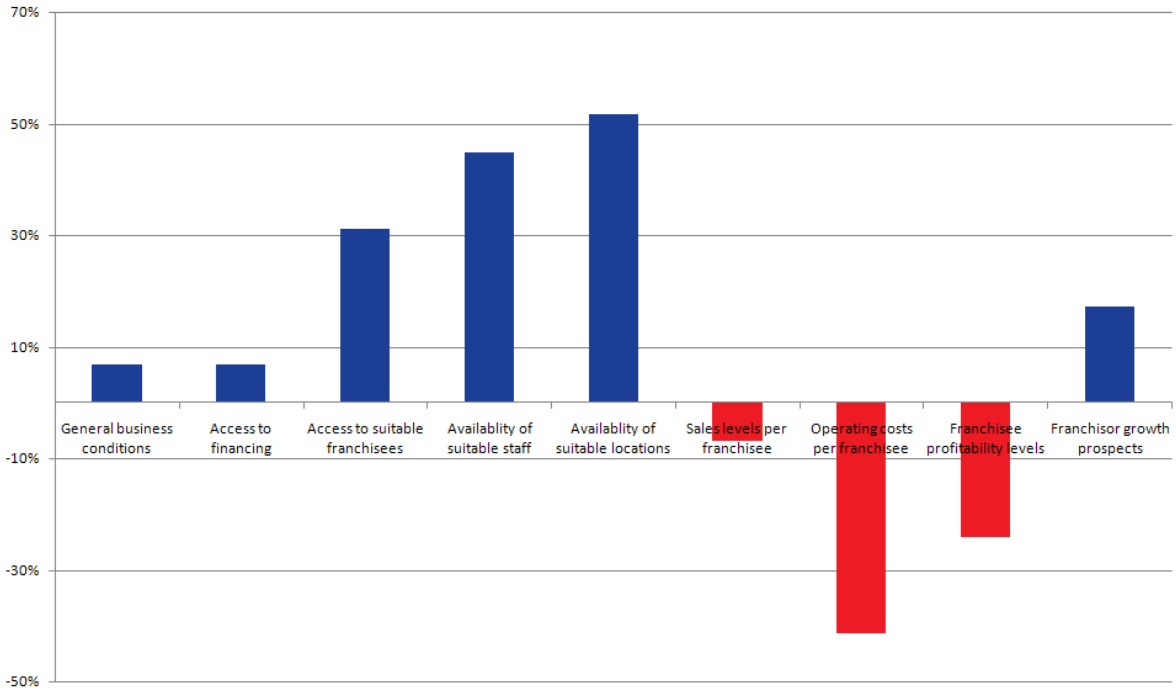




SERVICE PROVIDER EXPECTATIONS (next 12 months)



NET SERVICE PROVIDER EXPECTATIONS



The following charts plot net (i.e. difference between those expecting conditions to be "better" and "worse") franchisor (blue) and service provider (grey) sentiment toward individual variables overtime.

FRANCHISOR COMMENTS

The following are franchisor comments in response to the question "[h]ow are things looking in your sector?"

FOOD AND BEVERAGE RETAIL

- We are experiencing a dramatic lift in retail sales, due mainly to a re-positioning of the brand and associated marketing activity. Research has shown that in the current economic environment it is important to clearly define the benefits of products that are marketed on quality and not price. Franchise sales are fairly stagnant - due mainly to the fact that the banks are not as forthcoming with funding for new stores as they have been in the past....coupled with the fact that property prices has declined and therefore gearing becoming higher. However, good store locations are now available - with the power of negotiations being on the lessee's side.
- Retail Liquor - With new legislation due we are having to examine different methods of communication and advertising. Supermarkets and small independents' are forcing prices down, reducing margin and creating unrealistic consumer price points. Hopefully a reduction in issuing liquor licences and closure of others will bring some order back to the industry.
- Coffee Cafe Franchise - Continues to be competitive. Opportunities available / freeing up. Anticipate good growth for us in 12 months ahead.
- Retail Food - Sales have increased slightly over last couple of weeks, spring? Input costs have risen, squeezing margins. Exit prices will have to increase.

RETAIL (OTHER)

- Footfall has been quite low over the past 12 months but this seems to be increasing; our conversion rate has remained quite steady - with less people tending to purchase more.
- Retail is still under severe pressure. Occupancy costs are the most significant factor with landlords generally impervious to changes in the market. Is a growing tendency for franchisees to consider simply abandoning their business at end of lease, and with access to new suitable franchisees with NZ experience, this is putting pressure on the franchise system.
- Retail - Flat market with customers very discretionary about their spend.
- Home Entertainment sector - It's been a very tough 12 months with increased overheads and overall drop in sales due to the recessions etc. A number of store closures due to consolidation and market forces and many franchisees facing lower profits. Landlords/leases continue to be the biggest challenge for controlling operating costs as well as getting the customers to start spending again. However we see light at the end of the tunnel as the rationalisation of our market has taken place and we see a period of consolidation again as we move into 2011.

EDUCATION/CHILDCARE

- We've enjoyed quite strong growth in both revenue and customers. These indications are that this will continue in to the new year.
- Childcare - More competition - although non-franchised. Increased red tape. Less facilities. Increased rent in facilities that are available.
- Education - Already getting a few more enquiries. Change in GST may make a small difference in the near future but I'm not expecting it to have lasting effect.

BUSINESS SERVICES & SUPPORT

- The Recruitment sector is extremely competitive and tight. Too many government depts, and corporates are conducting their own recruitment in-house.
- Finance - Volumes are down this year, however we expect a recovery in the next 12 months.
- Business Coaches - Client numbers are increasing, we are seeing businesses looking for help in troubled times, however we have also seen the number of start ups grow plus established businesses are looking at growth and expansion in some sectors. The sale of franchises has been slow, many inquiries but there is a reluctance to sign up yet.
- Financial Services - Always challenging, but sufficient service range to meet specific market opportunities.
- Business services – Same.
- Vehicle Finance - Inquiry and sales increasing slowly but steadily. Cost and competition likely to increase.
- Financial Services and Retail - We feel trade is solid and looking promising for the next period. Revenues have remained reasonably consistent and response to marketing activity has been positive.

AUTOMOTIVE REPAIR & SERVICES

- Rental Cars very patchy, upturn has fizzled, looking for strong summer but not sure it will come. Customers leaving bookings to last minute.
- Automotive Glass Repair and Replacement Industry - Sales have been down for the same period last year. Expect improvement and growth during 2011. The World Cup will help the tourist trade and we will get a spin off!

COMMERCIAL & HOME SERVICES

- Home Renovation - Conditions continue to be very competitive mainly due to the continued low level of new home building leading people normally engaged in this facet of the building industry migrating towards home renovation. Inquiry has picked up a little over the last two weeks and we would expect

this to continue over the summer months. Longer term prospects will be driven by net migration and associated new home construction and the movement in average house sale prices.

- Commercial Cleaning - Very competitive to get new work, with some companies quoting at min wage level just to get work.

- Home Services. Overall work levels are steady, Franchise sales are on par with last year, new areas are developing well and our general mood is positive. Financing is still a big issue with franchise sales but alternative avenues have been developed. The NZ market is not as buoyant as the Australian market.

- Commercial Cleaning - Quote levels are little higher than the past but the market is purely price driven. To retain sites we have to re-specify scope of works to reduce the cost. At least this way we retain margin. It is most unfortunate participants in our sector end up doing the same scope for less, therefore reducing profit margin. Essentially we are losing the margin that takes a good number of years to gain. I personally believe the Canterbury finance bail out and the Earthquake restoration funding combined with the major banks still hurting from the global meltdown we have some challenging times still to come. Having said that well operated businesses will become better businesses if they "cut their cloth" to suit this climate.

- Service industry is on the rise with some good contracts on board.

- Electrical Market - Our franchises are conversion franchisees where an existing electrical company is converted to our brand to gain access to business support, our purchasing power and our national customers. As the franchisor our growth will be slow although most companies we call are more receptive to discussing franchising and have a better understanding of how franchising works (in comparison to 5 years ago) Any growth of our franchisees this year will be influenced by our national customers budgets for new outlets or premises upgrades.

- Servicing commercial kitchens – A lot of price pressure, particularly in the Restaurant trade. Trade is down in the Restaurant retail sector i.e. many customers are looking at costs closely and if we cannot convince them of the benefit equation they see it at merely a cost that they can cut out of their business.

- Hydro seeding - Is being sustained with infrastructure investment (local and central Govt).
  Lawnfix: excellent local growth - no new franchisees. Keeping our head down - concentrating on net profit not risk or investment.

- We are a Franchisor in the appliance rental industry. Our sector will continue to perform well due to strong demand for our products and services in the marketplace. As a franchisor we are also experiencing strong demand from highly qualified business people looking for a resilient business model in these uncertain times. We are finding that access to capital is an issue at present though the type of Franchisee we are now attracting are usually well funded. We are also achieving good organic growth as our business is reaching maturity and our well established Franchisees are looking for expansion opportunities.

BUILDING

- Still very grim in building sector.

GARDENING

- Landscape Supplies - Commercial is still flat, domestic starting to pick up.

SECTOR UNKNOWN

- Very few (qualified) franchisee enquiries this year. Lots of lookers but few actually prepared to commit to anything. Availability of staff and locations in a good balance. Group sales continue to climb (since Nov 09) and we are now ahead of pre-recession levels. Some challenges with poor performing franchisees that should be selling but I expect many are fearful of entering the current employment market so they stick with the business.

- Turnover down. Units similar to 09. Mix has changed - budget options being sought by consumer.

- Market potential for our product ever increasing. Mobile franchise model a proven success with very successful franchisees currently operating amongst some under performers. Proven growth and increased profitability being achieved by the right franchisees but lack of confidence in the economy as well difficulty in obtaining finance an ongoing challenge.

- Calls down but the jobs for the franchise owners are real with limited tyre kickers so per job the dollar value higher in the maintenance business.

- Sales are on the increase which is in line with time of the year.

SECTORS IDENTIFIED BUT NO COMMENT MADE

- Garden supplies retail

SERVICE PROVIDER COMMENTS

The following are service provider comments in response to the question "[h]ow do you think things are looking for franchisors and franchisees?"

- The business climate is still uncertain at the moment so I suspect that there is not likely to be a lot of growth in the franchise area. But if redundancies continue there may be more people interested in entering the franchise arena. I also suspect that the GST increase may hit the franchise area a little hard in the short term.

- Even though theoretically the economists say we are out of the recession I believe things are still very tough out there, particularly with banks lending criteria so much tougher. It may be at least 12 - 18 months before we start to see some real traction in both the general business and franchise communities.

- The general uncertainty about the economy will remain together with a period of adjustment to the tax changes. Once people see the net effect in their weekly income there should be an improvement in confidence.

- Tougher work to make the same dollar.

- Looking stable, but no great growth expected, apart from the smart operators will do better than the rest. However I would not be surprised to see a modest uplift in the fourth quarter.

- Flat at best.

- I can't imagine things getting a lot worse, so would like to think the only way is up for franchisees and franchisors. However, we know there is considerable pain out there within many franchise networks. Franchisees struggling and, in turn, franchisors struggling. Royalty delinquency at an all time high for many franchisors. Optimistic the future will be brighter but harbor concerns about the strength of certain overseas economies important to NZ, like the US, UK etc.

- Financial uncertainty and lack of confidence expected to hold or slow recovery, at least in medium term.

- Franchise sales seem to be fairly flat. Some resale's 'though. The question is why would a good prospective franchisee who is employed leave employment in these continuing uncertain times and take on business risk? Franchisors need to get their systems really humming and should take the opportunity in these "quiet times" (as far as recruitment is concerned) to review their system. However many franchisors I suspect will not have the ability to fund such a review and government assistance to SMEs should be made available as in USA and UK.

- It will be a tough year ahead for all businesses including franchised businesses. Growth appears to be stalling and the world economy has still got a lot of poison to rid itself of.

- Franchisees and franchisors getting more realistic in driving the success of the actual franchise business model.

- Gradual improvement in economic conditions will rub off on franchises. Debt levels are being reduced and those franchisees who have done this will be in a stronger position.

- An interesting time. I am hopeful that after all the recent business failures, natural disasters and tax changes etc that people will move on and take opportunities that are showing out there as I am seeing "green shoots" in the market place. It is still very much a wait and see approach though.

- Same as previous survey. In general, conditions not getting better nor worse with environment now stable. Issue is that it is stable at a low level and at a level that businesses have been having to "hang on" in for some time. A number haven't been able to "hang on" this long and others will struggle to continue hanging on at this level. More properties are becoming available, and there are still plenty of good unemployed prospects out there so locations and franchisees are available. Evidence of existing leases being renegotiated at lower levels. GST increase will generally require additional working capital and other costs generally "creeping" up.

- Market conditions remain very tough with consumer spend down and likely (at best) to remain flat for the foreseeable future. Pricing remains very competitive as competitors all fight to attract sales and consequently pressure on margins has heightened. Poor Franchisees are being highlighted and franchisors are facing increasing challenges as they try and maintain confidence in their systems. Many Franchisors are reporting growing delinquency in the payment of royalties and requests for royalty "holidays". Franchise systems that have historically not focused on the profitability of their Franchisees are being found out. The above may not be a positive picture but it is reality.

- Far more optimistic outlook.

- The lack of confidence in the SME sector is having a very negative effect on all business.
  People are not willing to chance a possible opportunity. The longer this attitude persists the worse the situation will become unless Government does something positive.

- Activity is relatively flat and there are no particular signs of change. Now continues to be the time for streamlining operations and focussing on cost reduction.

Franchising Confidence Index

The purpose of the Franchising Confidence Index is to represent the views and expectations of franchising, an important domain of business within the New Zealand economy.

Franchising commands its own confidence index for at least two reasons. First, franchising is a substantial and growing domain of business. Franchising has grown considerably over the last 30 years, as the organisation form has permeated both countries and industry sectors. In New Zealand, as for other countries, franchising accounts for an increasing proportion of all retail and service sector sales. Similarly, franchising has had an unquestionable impact on many countries' economies and is widely acclaimed for its contribution to GDP, organisational efficiency, job creation and workforce training.

The impact of franchising on the New Zealand economy is significant, although difficult to quantify (the last franchise survey was made in 2003). Extrapolated figures from past franchise sector surveys have suggested there are more than 350 active franchise systems, comprising 14,000+ outlets, generating a level of turnover that may top $20 billion.

Second, franchising is a distinct form of organisation with unique characteristics and associated challenges. Given this, and the importance of the sector overall, it is clear the Franchising Confidence Index provides information of value to all key franchising community stakeholders - which includes franchisors, franchisees, suppliers, customers, service providers, and government.

Companies involved in franchising are as diverse as Foodstuffs (New World, PAK'nSAVE, Four Square), NZ Post, Fisher & Paykel, Contact Energy, McDonald's, Columbus Coffee, Fastway Couriers, Harcourts and Fletcher Building.

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