Stone Cold Franchisor... or Victims of the Economic Crisis?

By Colleen Murphy and Mahmood A. Khan

Introduction

Cold Stone Creamery first opened its doors to the ice cream market in 1988 in Tempe, AZ offering premium ice cream made in-store and combined with fruit, candy, and other mix-in options to create customizable made to order "creations." Cold Stone prides itself on the "experience" it offers rather than simply its ice cream alone. While the idea of mix-ins was not original, the concept was borrowed from Steve's Ice Cream of Somerville, MA; Cold Stone strives to deliver "The Ultimate Ice Cream Experience" thereby generating customer happiness.

Cold Stone's corporate headquarters relocated from Tempe to Scottsdale, AZ in 1997, and the first franchise store opened in Tucson in 1995. Today, Cold Stone's website reports there are more than 1,000 franchises in 47 states and another 400 international franchise stores in 25 countries (Anonymous, 2012a). Cold Stone merged with Kahala Corp in 2007 and formed Kahala Cold Stone; a franchisor, developer, and marketer of quick-service restaurants whose brand portfolio includes Blimpie, The Great Steak & Potato Company, Johnnie's NY Pizzeria, Samurai Sam's Teriyaki Grill, and Taco Time. In August 2013, the Canadian Serruya family, owner of the yogurt chain Yogun Fruz, purchased a controlling interest in the Kahala Corporation. Kahala has more than 3,035 franchise- and company-owned locations in 23 countries under such brands as America's Taco Shop, Frullati Café & Bakery, Great Steak & Potato Co., Johnnie's New York Pizzeria, NrGize Lifestyle Café, Ranch One, Rollerz, Samurai Sam's Teriyaki Grill, Surf City Squeeze and Taco Time. Kahala said the Serruya family's experience in franchising will help grow its brands in international and North American markets (Ruggless, 2013, Wiles, 2013). While it may appear to be a good idea to have cobranding, it raises some potential problems. First, cobranding may cannibalize both sales and image of one brand with the addition of another brand. Second it may cause operational confusion and third it may increase costs because of the need to train employees. Also, cobranding may confuse consumers regarding products being offered (DiPietro, 2005).

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Business Model

Cold Stone markets itself to potential new franchisees as "an experienced franchisor" that has been "making people happy since 1988," "consistently recognized for excellence…" and "renowned for offering super-premium ice cream for more than 25 years…" The concept centers on customer personalization. Customers choose from a variety of ice cream flavors and mix-ins, and then watch as employees blend their personally selected ingredients on a cold granite surface (hence the name, Cold Stone). This is the experience Cold Stone is selling. Although not its official mission statement, Cold Stone claims it strives to deliver the "Ultimate Ice Cream Experience". In addition to custom ice cream creations, Cold Stone offers an array of frozen products to include signature and customized cakes and pies, shakes and smoothies, and pre-packed ice cream.

Franchisee Concerns

Beginning in the late 1990's, disgruntled Cold Stone franchise owners began alleging complaints against Cold Stone, ranging from promises of big profits to a business model that doesn't work, as well as receiving vendor rebates to the franchisor from required suppliers with inflated prices, profit margin cutting national coupons, and franchise over-expansion. The franchisees reported an average decline in revenues of $50,000 from 2005 to 2011 and attribute the losses to failures and poor decision making of Cold Stone.

In 2008, the Wall Street Journal (WSJ) reported that numerous Cold Stone franchisees told similar stories of being misled with promises of big profits that they claim proved impossible to achieve and that were based on exaggerated scenarios for annual sales projections (Gibson, 2008a & b). Even when the corporation raves about the quality of the ice cream, numerous franchisees said that the numbers in Cold Stone's business model does not add up. The cost of running one of the shops itself was so steep that making a profit was daunting, especially in an economy where $ 4 scoop was pricey. According to the WSJ, some of these franchisees blame their failures on a flawed business model that included operations and overhead costs so high that making a profit was impossible (Gibson, 2008a; Bounds, 2008).

Franchisees claimed that requirements to purchase over-priced equipment and supplies, such as the Cold Stone's proprietary sweet cream mix, from mandatory sources further sabotaged any chance of turning a profit. The franchisees also claim they were told that

Figure 1

Cold Stone Franchise Units

YEAR	U.S.	CANADIAN	INTERNATIONAL	COMPANY OWNED
2014	968	155	278	22
2013	997	151	273	34
2012	1,049	135	239	37
2011	1,049	135	239	37
2010	1,163	13	181	35

Source: *http://www.entrepreneur.com/franchises/coldstonecreamery/282219-0.html#*

vendor rebates received by Cold Stone from the equipment and supply purchases would be allocated to Cold Stone's franchisee Flexible Marketing Program to benefit them. They claim they received no benefit for paying a premium to the required suppliers in addition to the required 9% monthly franchise fee for royalties and advertising. Franchisees also contended that national 2 for 1 coupons that required the franchisee to incur the cost for the freebie contributed to their profit woes. Finally, franchisees claim that rapid franchise expansion in the 1990s resulted in stores being located so close together that they competed for customers and further precluded their ability to be profitable. Blue MauMau (2012), a news source for franchise owners, ranked Cold Stone as the 19th Worst Franchise to own in 2012, as measured by a Small Business Association loan failure rate of 41.93%. Figure 1. shows the decrease in the number of U.S. Cold Stone franchise units from 2009 to 2013.

Cold Stone's Position

Cold Stone claimed that it wanted all of its franchisees to succeed, and blamed franchisees for their own inability to successfully implement the business model. Cold Stone insists that the quality of store operation is a direct determinant of profit and franchisee success. The WSJ reports that Cold Stone claimed to carefully screen and selectively award franchises to only about 2% of applicants, but in the same article the company is quoted as saying, "…minimal restaurant experience, a lack of desire to do local-store marketing, or the inability to be operationally excellent can all contribute to a franchisee's inability to succeed." Cold Stone also states that it doesn't provide projected profits to potential franchisees; rather it provided actual figures from franchise reports (Needleman, 2012).

According to the WSJ, Cold Stone says it has established relationships with product and equipment distributors to maximize efficiency, quality and economies of scale (Needleman, 2012). In a CNBC television interview in 2011, Cold Stone's president (as well as a single franchisee and an attorney representing both the National Independent Association of Cold Stone Creamery Franchises, Inc. and Cold Stone) discussed, among other topics, the common practice of vendor rebates in the franchising world and that the rebates Cold Stone receives are in fact used to benefit its franchisees. Regarding the claim of rapid expansion at the detriment of its existing franchisees, Cold Stone planned to slow expansion following the merger with Kahala in 2007.

Dilemma

The disadvantages to franchising primarily arise from an uneven franchisor-franchisee relationship that leads to dissatisfaction of either or both parties. Failure of the franchisor after the franchisee has invested is one of the major disadvantages to franchisees. This is a risk which franchisees do understand but the performance of franchisors cannot be prejudged. Sometimes this results from the inducement of the franchisors which may even extend to the line of misrepresentations (Khan, 2014).

Cold Stone franchisees blame the corporation for a business plan that isn't achievable. Cold Stone places the reasons for failure squarely on the shoulders of the franchisees and a tough economy in the late 2000s. So who or what is really to blame? According to Jeff Fabian, a franchise and trademark lawyer, the Cold Stone case is an important one to watch for franchisees and franchisors alike. If the franchisees are able to sustain their lawsuit, it will not be surprising to see similar suits filed against other franchise systems as well (Fabian, 2012). Improper management or abrupt changes in management may affect all franchisees within a network. At times, poor performance of the franchisor is interpreted by consumers as poor performance of the individual franchisee, irrespective of how profitable a restaurant has been in the past (Khan, 2014).

Franchisees Take Action

In 2010, a group of more than 120 Cold Stone franchise owners formed the National Independent Association of Cold Stone Creamery Franchises, Inc. (NIACCF) with the goal to "articulate and advocate the

needs, interests and goals of its members in the context of a constructive and cooperative relationship with their franchisor" (Anonymous 2012b, 2013). In 2012, the NIACCF collectively filed a lawsuit in a Florida court against the parent company, Cold Stone Creamery Inc. for failure to provide information regarding funds received by Cold Stone from vendor rebates and unused gift cards, how much of the rebates were actually allocated to the Flexible Marketing Program, and how Cold Stone managed revenues and interest on sales of unredeemed gift cards (Ruggless, 2012). The lawsuit also seeks disclosure of pricing information for the equipment and supplies for which Cold Stone received vendor rebates to determine if prices were inflated to benefit the franchisor. According to one franchise owner, "Our plan is to find the truth and to better the system, better our stores, and therefore our profitability" (Oches, 2012). The lawsuit requested Cold Stone to provide the information in question to the franchisees (ANSA, 2012).

In response, Cold Stone moved to stay, citing the requirement for individual franchisees to use arbitration in resolving disputes with Cold Stone regarding franchisee concerns in accordance with a clause in their franchise agreements. The Florida District Court found in favor of Cold Stone and Arizona's arbitration laws and granted the stay.

Economy

And then there are the economic considerations. When the global economy tumbled in 2008 and 2009, the food industry wasn't exempt. Rising oil prices drove increases to fuel costs which translated into increased food costs and finally, increased prices to consumers. Food prices increased by 20-30 percent and that caused restaurants to raise prices of food on the menu (Epstein, 2008). At a time when consumers were pinching their pennies, Cold Stone's $4 creations were an indulgence that didn't make the cut in household budgets. The US economy during 1990s was facing very tight situation. Although there was a sharp rally on Wall Street sparked mainly by the Fed's action most consumers remain unimpressed. Consumers were not doing much buying and were so wary that the Fed's 14 prior rate cuts since the recession began in July 1990 have provided little stimulus (O'Boyle & Joan, 1991). Despite the numerous cuts that restaurateurs have made during past couple of years, there was not much left to work with except menu prices. However, it was very hard to raise prices because customers were not willing to pay the increases. The summer floods of 1993 were predicted to push the price of commodities during 1994 by the largest margin since 1990 (Romano, 1994). Restaurant operators, hit by the realities of a faltering national economy and rising costs of goods and services were facing the biggest challenge in years to keep their businesses profitable. Despite rising receipts industrywide, the average number of meals per person, purchased at US commercial restaurants dropped significantly (Papiernik, 2001). In short, the year 1990 was a difficult one for the food service industry.

Although the US franchising business was not immune to prevalent economic conditions, it used strategy that helped in its survival. As the US restaurant industry became saturated, many chains focused on international markets. For example, in 1990, McDonald's international operations contributed an estimated 6.3 billion to its system-wide sales which accounted for one-third of the total sales. Similarly KFC expanded the number of units internationally (Anonymous, 1991). A 2012 WSJ article examined the Cold Stone litigation and noted that, "The food sector was hit particularly hard during the recession…" and "Specialty chains like Cold Stone Creamery may have suffered far more than other chains…"

Discussion Questions

It is highly recommended to use Cold Stone's website www.coldstonecreamery.com before starting discussion on this case.

- As a Cold Stone executive, what actions would you take to address the concerns of the franchisees and attempt to move past the 2012 lawsuit?
- Do you believe the Cold Stone franchisees should accept more responsibilities for the inability to be successful? Or do you believe they were victims of a greedy corporate system?
- How do you think the Florida court's ruling in favor of Cold Stone and the arbitration agreements will impact the franchisees concerns and how will this impact the company going forward?
- Do you believe the 2008/2009 economic crisis had a role in the struggles of the franchisees, or is it a convenient scape goat for Cold Stone?
- In light of this case study, what are the advantages and disadvantages of franchising?
- What changes would you recommend in franchise agreement to stop such issues from reoccurring?

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