

THE JOURNAL REPORT: SMALL BUSINESS

The Inside Scoop

Cold Stone Creamery attracted a lot of franchisees thinking it was a sure thing. It wasn't.

By RICHARD GIBSON

Earlier in this decade, Cold Stone Creamery was one of the hottest franchises around. The super-premium ice-cream stores attracted scores of franchisees hungry for a piece of the "Ultimate Ice Cream Experience."

Now many franchisees are selling their stores, overwhelmed by soaring bills and shrinking profits. Some have lost their homes, broken their retirement nest eggs or filed for bankruptcy.

What happened?

Even as they rave about the quality of the ice cream, numerous franchisees say the numbers in Cold Stone's business model didn't add up. The cost of running one of the shops was so steep that making a profit was daunting, especially in an economy where a \$4 scoop was a pricey indulgence, they argue. They also contend the company cut their margins even further by offering two-for-one coupons and making them buy costly ingredients from a single supplier. Some argue that the company's rapid expansion crowded stores too close together -- and brought in too many inexperienced franchisees.

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A CONEFUL OF TROUBLE

- **The History:** Cold Stone Creamery used to be one of the hottest franchises around, drawing scores of prospective franchisees.
- **The Latest:** Owners have been closing their stores in droves.
- **The Argument:** Many of the ex-franchisees say that Cold Stone's business model doesn't work -- and the company made those troubles worse.

A number of franchisees also contend the company misled them, giving them promises of profit potential that proved unrealistic or inaccurate revenue numbers from existing stores. And some say that they got little help from the company as

their stores went under.

"They have a defective business model, there's no question about it," says Ken Gornall, a former franchisee who closed his Glendale, Ariz., store last October. He adds that the average revenue numbers he received before signing up "were quite misleading," exaggerating likely annual sales.

Cold Stone says more than 100 of its stores closed last year. That's up from 60 in 2006. One list on a Cold Stone Web site recently had 303 stores for sale -- more than 20% of the company's 1,384 as of last December.

This "combination of numbers is very, very high," says franchise attorney Eric Karp of Boston law firm Witmer, Karp, Warner & Ryan LLP. "I think it's a symptom of bad news and not good news." (Mr. Karp, who specializes in representing franchisee associations and individual franchisees, hasn't represented Cold Stone store owners.)



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Cold Stone has been franchising only since 1995, and Mr. Karp concludes that 12 years or so would be an unusually

short time for first-generation franchisees to be cashing out and retiring.

Chris Prasifka, Cold Stone's president, acknowledges that the "inventory of stores for sale now is higher than it has been." But a company spokeswoman terms the for-sale number "at par with industry expectations," given "the economically challenging times."

She adds that about 230 of those listed for sale are stores in operation; the rest are "awards" to develop future stores.



Ken Gornall

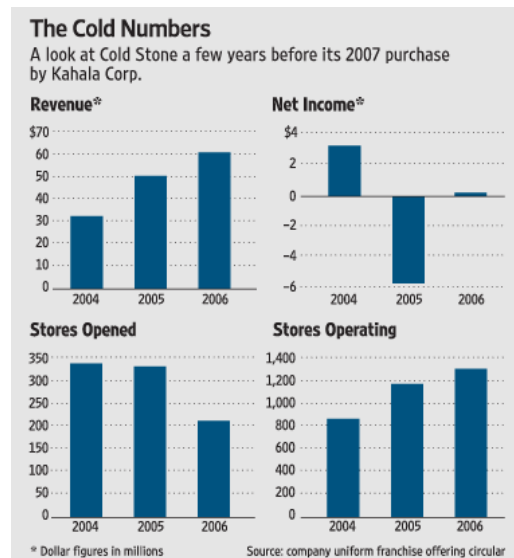
The company also contests the franchisees' charges. Cold Stone insists it doesn't provide profit potential to prospective franchisees. It also says the revenue figures it gave for existing stores were based on franchisee reports.

Costs, meanwhile, "will depend on how well a store is operated," Mr. Prasifka says. Cold Stone says it uses a one-stop distributor to ensure efficiency, quality and economies of scale. It adds that franchisees can buy ingredients

elsewhere at lower prices if the product is identical. Cold Stone says it won't distribute national two-for-one coupons this year, after franchisee complaints.

And the company says that it's selective about adding franchisees, typically approving about 2% of applicants. As for their chances of succeeding, Mr. Prasifka asserts that "it's no different from any other business. You've got to work it." He adds, "It does take a year or two to understand the business."

Overall, Mr. Prasifka says, "We want all franchisees to succeed. However, 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 was a stand-alone brand for 19 years before being acquired by fast-food franchiser Kahala Corp. last year. Other Kahala brands include Blimpie sandwiches and TacoTime Mexican food. Kahala's plans call for slowing Cold Stone's expansion, reducing new-store construction costs and finding ways to grow average annual store sales to about \$500,000 from about \$360,000 now.

For many franchisees, the new ownership comes too late. Formerly an independent real-estate agent, Mr. Gornall signed up for a Cold Stone franchise in June 2004. "The stores seemed busy all the time. You assume that 'busy' equates to profitability," he says.

Before buying, Mr. Gornall called half a dozen franchisees. "No one said, 'This is a bad deal,'" he remembers. But it soon became clear that something was amiss. Mr. Gornall already faced high overhead such as a \$3,700-a-month lease, he says. Then, he says, the company squeezed his margins further by mandating that he buy what he considered expensive ingredients, in larger quantities than he needed. Mr. Gornall adds that the company's promotional couponing shrank his profits.

Along the way, he says, he didn't get much help, either from Cold Stone or the area developer -- a company representative assigned to sell franchises in the area and monitor the franchisees. The area developer, Sean Brown, visited his store only once, Mr. Gornall recalls, and didn't have any good ideas for boosting sales.

Mr. Gornall and his wife borrowed on their personal credit cards to pay the store's bills. But after their losses exceeded \$100,000 last fall, they gave up and closed their store. They lost their house and are filing for bankruptcy. "It's been pretty devastating," he says.

Still, "I share some responsibilities" for failing, Mr. Gornall adds. "Maybe I should have closed sooner, but I kept on thinking things would be better."

The company wouldn't comment directly on the Gornalls' case. But Mr. Prasifka says, "When a franchisee asks for support, we make it a priority to get someone from our team to visit them, discuss their situation and get to the root cause."

He says if franchisees aren't satisfied with the support they receive from their area developer, there are "multiple resources," including an ombudsman, available. But he acknowledges that "during tough times, we will have some franchisees who will struggle."

The company didn't comment on Mr. Gornall's complaints about Mr. Brown, which were echoed by several other ex-franchisees. Cold Stone terminated Mr. Brown in January 2007 after he "habitually failed to pay royalties, rent, advertising and other amounts" on Cold Stone stores he owned, according to a company document in a tax-levy dispute with the government in U.S. District Court in Houston. The dispute arose over who should pay income and employment taxes owed on Mr. Brown's stores. The government looked to Cold Stone, but the company argued that Cold Stone didn't have an interest in Mr. Brown's properties at the time the lien arose. Mr. Brown declined to comment.

Citing surveys of franchisees, Mr. Prasifka says that overall "they're very satisfied with their area developers," whom he calls "world class." He says three of the two dozen or so have left the system in the past two years.

Some franchisees argue that the chain expanded too rapidly in its early years. "They did overbuild across the country, no question about it," says Michael Goldman, a Northern California franchisee with seven stores and a seat on Cold Stone's National Advisory Board, a group of franchisees who meet to discuss the business and give franchisee feedback to management.

The rapid growth meant new stores were frequently close to old ones, cannibalizing sales, Mr. Goldman argues. "I'm sure there are sites that should never have been picked and franchisees that should never have been picked" because of their lack of experience, he says.

But while many failed Cold Stone franchisees were new to franchising, experienced franchisees also have lost money. "This was not our first rodeo," says Deborah Lickteig, whose family had operated KFC chicken outlets in Arizona and New Mexico.

"We worked it real hard for a year," she says. But she and her husband sold their store in June 2006 after weekly sales at the San Antonio outlet fell several thousand dollars short of what she calls "skewed" pro-forma figures from the



Deborah Lickteig

company. A glut of Cold Stone stores in the area, high food costs and the buy-one, get-one-free coupons made things worse, she says. Cold Stone wouldn't comment directly on the Lickteigs.

Former Florida franchisee Cecil Rolle has become more nettlesome to Cold Stone than most. After the company terminated him last year, it alleged in a Florida circuit court action that he had been caught removing equipment from one of his three Florida stores in the middle of the night. The company also filed suit in federal district court in Tallahassee to recover what it said are substantial sums he owes.



Cecil Rolle

Mr. Rolle acknowledges seeking to remove equipment and withholding payments. But he and his wife have countersued, contending among other things that they were misled when told they would make "right around a 20% profit" on a mall store they bought. Cold Stone wouldn't comment on Mr. Rolle's allegations, but in a recent email to franchisees, a Cold Stone attorney sought to counter what he termed "Mr. Rolle's inaccurate and misleading attacks against us."

Mr. Rolle is trying to organize other franchisees for a possible class-action suit seeking some remedy from Cold Stone and Kahala. He spends much of his days at his Gainesville, Fla., home emailing with disillusioned former and current franchisees. "I feel like I'm doing something good," he says. And last month, Mr. Rolle opened an ice-cream shop in Tallahassee -- on the site of a former Cold Stone store.

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