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Franchisors should focus on survival of the system

By Dennis L. Monroe

Many lawyers and franchise professionals seem to be stuck in a rut as to how franchise businesses should operate, particularly with regard to the franchise fees and royalty matrix. In light of the kind of return on investment franchisees are getting in this tight economy, higher commodity prices and escalating labor costs, the proactive franchisor needs to look at the economics of its franchise system. It should ask how it charges for their intellectual property rights, services and overall partnership with the franchisee community.

We have seen franchisors take a more active role in providing financing support to help franchisees grow. But we have not seen a great deal of creativity as it relates to the franchise fee structure, or franchisors who are willing to revise the way they structure royalties, franchise fees and advertising.

Franchisors figure they have a system, by and large, that complies with the economics originally proposed in the Franchise Disclosure Document (FDD) so why change? There are a number of compelling reasons for the franchisor to change its view of what it charges franchisees:

- Many systems and franchisees are being squeezed on their inherent cost of goods, labor and overall margin.
- There is a huge emphasis on remodels and other costs to upgrade franchise sites, but in many cases current economics do not support these upgrades.
- A good share of franchisees in a system are in default of development agreements because of a lack of financing and tough unit economics. An adjustment to the basic royalty structure would certainly help.
- Franchisees need a reasonable exit to get value for their hard work. An adjustment by the franchisor of the economics to the franchisees may be a great value generator.
- The survival of the franchise system.

The following are some alternative ways the franchisor can look at this economic issue:

Royalty stream Almost all franchise royalties are based on a percentage of revenue which in no way recognizes the profitability of a franchisee. Think about the following ways to restructure the royalty fee:

A graduated royalty structure based on the level of sales The lower the level of sales, the lower the royalty. The royalty would continue to go up until unit system average volumes are met. Once the average unit volumes are met, then after a certain increment (call it a "make up"), the royalties would be either capped or adjusted downward for higher volumes. The higher volume restaurants do not, necessarily, take more effort from the franchisor. This approach would create a bell shaped curve for royalties versus sales. A sophisticated franchisor can determine how this economically plays out for the franchisee, and how it also provides reasonable expectations of income for the franchisor.

Profitability really is key. A franchisee should not be penalized for opening an unprofitable store where there is a good chance of rising sales and improved profitability. Most stores in today's market have a start-up period which may be one, two or three years before they reach profitability. The franchisor should be a partner with the franchisee. The franchisee could look at a percentage of cash flow versus percentage of revenue. Obviously, as the store becomes more profitable, the franchisor should be entitled to a higher percentage of the profits up to a certain point. When the profits reach that certain point, the percentage of profits (or cash flow payable to the franchisor) should be reduced as not to discourage the franchisee from creating significant cash flow from each unit.

Rather than viewing royalties as a percentage of sales, why not look at a percentage of gross profit (sales less cost of goods and labor)? With the cost of labor, materials and goods increasing, the profit squeeze for the franchisee is a real issue. Franchisees need some protection in order to appropriately perform in a franchise community; and what better measure than gross profit.

An issue in recent litigation is the profitability or lack thereof of product items (such as hamburgers or tires). These loss-leader items sometimes are advertised and sold below their cost. Franchisors might look at profitability based on product mix using ideal product cost and charge a sliding royalty on product profitability. This way there is no royalty paid on products that do not contribute to the profitability of the franchisee and highly profitable products may cause a higher royalty.

As a franchisee grows, the actual royalty goes down. For instance, there is a certain royalty charged for four stores but if the franchisee develops the fifth store, then the royalty on all five stores goes down. This approach encourages development. If you think about it, the franchisor's cost for that additional store is going to be incrementally less than the first store; and when blended with additional stores, may improve the franchisor's royalty stream.

Advertising Franchisors should look at a new way to charge for advertising. For most major franchisors there is obviously a system-wide creative component that the franchisor needs to coordinate and oversee. However, the cost of this should be limited to something in the neighborhood of 1 percent of sales. After charging this basic 1 percent, I would suggest advertising dollars and reimbursement to the franchisor be based on improved sales versus strictly a reflection of cost. It is also important that the franchise systems be based on local advertising, particularly the co-op approach and letting franchisees use the creative materials the franchisors have developed to control much of their own advertising. We're particularly seeing cost savings with the use of social media where, in many cases, in-store and local marketing are much more important than regional and national marketing.

Franchise and development fees The franchise fee should be no more than the direct, out-of-pocket cost plus some reasonable allocation of franchisor overhead for opening a store. The franchise fee should not be based on what everyone else is charging. In many cases the fee for development rights seems to discourage development because of the upfront cost. Given the risk the franchisee is taking, there should be a minimum amount charged for development rights. The key element is to have a realistic development schedule that can be met and satisfied by both parties.

Changes in the future A key element that I see is the flexibility by the franchisors to adapt to changing circumstances. Therefore, one of the things I would like to see in the FDD is that the franchisor will never charge more than is provided in the FDD but will review and try to monitor profitability of the franchise system and cooperate with its franchise advisory council in looking at alternatives. I know my lawyer friends will say this is suicidal and probably invites litigation; however, if properly structured and with the cooperation of a meaningful franchise advisory council, this may be an effective approach. FT

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