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Two Key Franchise Issues: Development Rights and Capital Expenditures

When you review the Top 200 list, you realize the big influence franchisees have on their franchise systems. Nonetheless, there's always some tension between franchisor and franchisee. This often appears in two areas: development rights and required capex for remodels, upgrades or new equipment.

Development Rights: Often, a franchisor wants to sell development rights to franchisees who appear to be good growth prospects. The sale of rights is also a plus for the franchisor and provides assurance to shareholders the royalty stream is going up. The problem with development rights is they are often more of a negotiation than a carefully thought out plan for growth. As a franchisee, consider the following:

• Are development obligations reasonable in terms of time to develop, number of stores and geography? We have renegotiated agreements because the franchisee couldn't find enough sites on time.

• Are the sites affordable? Site cost must fit in with the unit economics. No franchisee can afford to pay excessive rent and occupancy costs—the kiss of death to new development.

• If, because of market conditions, store performance, or questionable business rationale for opening new sites, development can't proceed, the agreement should provide a safety valve. Safety valves can be development extensions, an agreement between franchisor and franchisee to negotiate in good faith to resolve, or some type of monetary solution. Franchisors often want upfront development fees based on the number of potential units in the territory. The commitment is usually 50% of the franchisee fee (which is sometimes credited when the store is opened) or a flat amount per potential site. In all cases, this approach may be short-sighted. It's better if development rights have a de minimis cost.

• If a franchisee is in default of the development agreement, it also could be in default under the franchise agreement. This is a draconian approach to two separate kinds of business actions, development and store operations, and should be avoided.

• Franchisors need to be clear about the development assistance they will provide franchisees. Some put together a development program where services are provided to the franchisees for a cost. Franchisors will sometimes use in-house personnel or secure outside services to help find sites, get governmental approvals and negotiate leases. However, most leave site selection and development to the franchisee, with franchisor approval rights. The franchisee should understand what is involved in site approval prior to undertaking development.

• Like everything in development, financing is key. The development schedule must reflect timing and the ability to get lender financing, or by way of a program set up by the franchisor to finance new development. If the SBA is going to be used, or commercial banks have to be found for each site, development will take more time. Franchisors and franchisees need to recognize this and understand to what degree financing is available. Is it 50% loan to value or 80% loan to value? That ratio will have an effect on the turnaround time for investment, as well as the ease in finding a source.

• Most of the Top 200 franchisees have existing training and management people to do store openings. In agreeing on a development schedule, the franchisor needs to take into account the franchisee's ability to train employees and open new stores. The franchisor should not just look at the development process.

In summary, it's important development rights are realistic, obtainable and negotiated in good faith, with each side getting what's necessary for effective development and yet still keeping the franchisor protected.

Capital Expenditures: When sales decline or the system loses market share, franchisors seem to first request remodels, equipment upgrades, technology changes, new services or changes in menu items, which cost franchisees money. The franchisor should consider the following before requiring franchisees to invest further in the system:

1. Did the franchisor prove these capital expenditures will show an appropriate rate of return? Did they test the changes in corporate stores, or did they test with a sample group of franchisees? Will these expenditures bring store improvements? Is the rate of return adequate in the franchisee's mind?

2. How much time will it take to make the remodels or equipment and technology upgrades?

3. What has the franchisor said in the past or in the franchise documents about remodeling obligations? Does that obligation tie out with the useful life of the assets that are being replaced?

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4. Besides return on investment, what has the franchisor learned about any of these changes? Whether it is new services or menu changes, what type of sales lift will the unit get? Every change requires expenditure of time, training and dollars.

5. What type of financing is available to comply with the franchisor's requests? If the franchisee has financed its existing assets, there normally is a blanket lien on all of the locations' assets. So, to finance new expenditures, it's necessary to get lender consent. The franchisor needs to consider the type of financing the franchisee can obtain to make capital expenditures. What can the franchisor do to facilitate those upgrades? (Some options are vendor leasing programs or providing incentives, such as additional development rights or some type of royalty relief).

6. What is the useful life of the capital expenditures the franchisor is seeking to get from the franchisee? If the life is very short, then this can be somewhat problematic. The improvements might have to be written off quickly, which affects the profit and loss of the unit.

The franchisor should consider all of the above before requesting remodels, equipment upgrades, technology changes or new services or products. Although there will always be tension between franchisee and franchisor, taking appropriate steps to address the issues outlined above can help reduce it.

I want to thank my partner, Ryan Palmer, co-chair of our Franchise Department at Monroe Moxness Berg, for helping me with this article.

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