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A Fair Approach to Franchising

By Dennis Monroe

As franchisees become more sophisticated, they are more discerning when choosing that next opportunity. Assembled with the help of my partner, Jim Wahl, below is a checklist of the key elements franchisors need to offer when they set out to create a successful system for both parties.

1. Unit Economics—The unit economics must be clear to the prospective franchisee at or above market economics. Most restaurant franchises should have operating store-level profits of between 12% and 18%, after rent and all franchisee fees and royalties. More than anything, this is the basis for a successful franchise.

2. Cost of Franchisor Support—The franchisor needs to clearly define the support it will provide to the franchisee and its related costs. Subway pioneered the way to look at support and costs by having the franchisor make money from royalties and not from other items, such as food, supplies, marketing or franchise fees. There are many cases where franchisors have tried to make a profit on ancillary services or products and have crushed the system—a most notable example is Quizno's. The franchisor had an upcharge on food, which eroded the margin for the franchisee.

3. Market Rate Royalty—The trend now is that the royalty should recognize profitability as well as just revenues. A thoughtful franchisor will recognize profitability issues, such as significant discounting, start-up expenses or the ramp-up to get to a sustainable volume. In many cases there should be a sliding scale for the royalty, reflecting these issues.

4. Field Support—It is important the franchisee gets the benefit of the system. That can most easily be done by the franchisor's field support. They know the average unit volumes and costs in a particular area, and can help the franchisee make operational changes to meet or exceed system averages.

5. Labor Costs—The franchisor should come up with new ways to manage labor costs, such as products that are not as labor-intensive. The franchisor should emphasize technology, not just for cost savings but for monitoring the overall restaurant, so there is a real-time understanding of sales, product costs and labor.

6. New Product Development—One of the lifelines of the restaurant world is new products. Applebee's has gone for quite a few years with no significant breakthrough in new products. This is a problem for the franchisees, as they rely on the franchisor for new offerings that will increase repeat customers.

7. Embrace Self-Innovation—The franchisor should allow franchisees' self-innovation and not reject it because of control issues. Within reasonable limits, franchisee creativity should be embraced, and there should be a defined process for evaluating innovations proposed by franchisees.

8. Site Selection—It is important for the franchisor to be involved in site selection and to provide the appropriate demographic information to the franchisees so they understand the target market and the areas that have the greatest chance of success. We know site selection is not a science but an art; however, the more information the franchisor can provide to franchisees, the better the chance for successful restaurants.

9. Flexibility on Development Schedules—I have seldom seen a franchisor tell a franchisee not to develop stores. Franchisors need to set reasonable development expectations. The franchisee's realistic capabilities should always be taken into account.

10. Financing—The franchisor and the system need to be finance-friendly. This means the franchisor is willing to meet with and seek out financing sources for the franchisees. They also need to provide support information, particularly outside valuations of their system. From a legal standpoint, the franchisor needs to be involved, allowing lenders to have certain rights so the franchise system does not get a black mark as a troubled situation. This may include granting remarketing rights that give the lenders flexibility in case of a default, or helping out with defaults on behalf of the franchisee borrower.

11. Miscellaneous—The franchisor should recognize changes in economic conditions and be reasonable about allowing closure of unprofitable stores. The system can better remain intact if the franchisee has a right to relocate to a better site and, in general, move things ahead.

These are all issues that need to be grappled with, as our franchise world is still stuck in the last century. There has not been as much innovation as there should be. Still, there are some signs of change: Consider, for example, PE firm NRD Capital, whose investing parameters dictate that they acquire only franchisee-friendly brands. NRD and groups like them are trying to be innovative and look at systems differently.

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