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Rethinking Your Franchise Agreements

By Dennis Monroe

Last month's column about an evolving franchise model is particularly relevant in light of emerging disputes between franchisees and franchisors and how it is being played out in front of the Federal Trade Commission. To continue to evolve the franchise model for better results, I've put together 12 items that I'd like franchisors to focus on:

1) Franchisors should be partners with franchisees, as well as recognize the importance of the legal relationship. This means once the prospect becomes a franchisee, they have an effective stake in the future of the company, particularly in the areas of capital expenditures and improvements, shared financial information, creation of best practices and first-hand knowledge of new products and marketing.

Franchisees should have significant input in all of these, versus a top-down approach. This sets a new dynamic and will create a better result. Don't share just successes, but also failures, so franchisees understand the pitfalls. Set up protocols so when one franchisee is struggling, other franchisees can partner with them to help make them successful. The resulting culture should be one of a partnership.

2) Look at multi-revenue streams. For instance, a QSR that offers in-store dining and drive-thrus can add meal replacement pick up easily. Consider adding a food truck for onstreet sales or festivals, plus catering, and third-party or inhouse delivery. Explore helping franchisees obtain sub-licensing rights to non-traditional sites, such as colleges, hospitals and music venues. Traditionally, the franchisor retained these rights for themselves, but if carefully negotiated, this can provide franchisees with an additional revenue source.

3) Consistently re-evaluate unit economics. Are units making a threshold profit after franchisee royalties? The discussion from my article last month about an evolved franchise model for the industry is particularly relevant in light of the current environment of disputes between franchisees and franchisors, much of it concerning capital upgrades in an attempt to increase sales.

4) Look at initial and future capital expenditures. The other corollary is the return on investment, which coincides with how much initial capital to spend, as well as how much to continue to put in for remodels, rehabs and upgrades. The minimum goal is to have the annual revenue equal to three times the initial investment. Additionally, investments should strive for a 20% plus return.

5) Stay current with common and evolving technology. Recognize that technology is a way to be efficient in labor expenses, attract customers and keep track of profitability. Technology needs to be constantly upgraded with a uniform approach systemwide. If a franchisee comes up with a new idea for software or technology, it should be shared with the other franchisees to see if it should be implemented systemwide.

6) It's critical to share financial information and best practices between all partners. Individual unit numbers can be on an anonymous basis if necessary, but it's important that everyone in the franchise system use a common general ledger system so that when they are comparing costs, they know exactly how labor, food or occupancy costs equate.

7) Re-evaluate the use of personal guarantees. Personal guarantees are seldom enforced. If your franchisee is well capitalized, you consider whether they are really necessary. Be flexible in terms of recquiring guarantees, and if you decide to have them, there should be a limitation and possibly be allowed to burn off.

8) Do you really need a right of first refusal? The franchisor's right of first refusal creates all kinds of problems for franchisees when they want to sell. Franchisors have the right to approve an assignment, but the approval cannot be unreasonably withheld. Since the right of first refusal is not helpful to an effective transition for franchisees, it should be taken out of new franchise agreements, or at least be converted to a right of first offer.

9) Development rights are tricky. Often franchisors try to sell development rights for large territories and get the money upfront. A better approach is the right of first offer for surrounding territories, so existing franchisees don't have to use capital to tie them up, but have the right to make an offer if the franchisor decides to expand in adjacent territories.

10) Non-competes and post-covenant provisions. Non-competes should be reasonable, even during the term of the franchise period. The reality is that many multi-unit operators will choose to develop other concepts besides yours. Technically, every restaurant competes for share of stomach, so there should be reasonable non-competes, while still protecting your intellectual property.

11) Reduce royalties until the location is profitable. Franchisors should acknowledge that there are start-up costs to getting a franchise up and going, and therefore until the franchise location is profitable, the royalties should be reduced. Once there is profitability the full amount can be charged, as long as it can be justified. Does the average 5 to 6% being charged justify the services the franchisor performs? I think it's more important to have royalties that are sustainable and reasonable and allow the franchisee to have the profitability necessary for success.

12) Is a national ad fund necessary? While there is still a need for strong brand collateral at the national level, most of the marketing will be done at the store level through local advertising and social media. Many franchises are still requiring franchisees to contribute a set amount into a national ad fund, which I'm not sure is necessary. To be successful, franchisees should receive branded materials and guidelines from their franchisor, but after that they need to be able to localize their approach.

The days of thinking of franchising as a parent/child relationship are over. Mutual respect and partnership is the new dynamic that will go a long way in creating a healthy and financially successful system.

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