THE FRANCHISOR/FRANCHISEE ECONOMIC RELATIONSHIP - IT'S A NEW WORLD !!

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Almost everybody has noticed that their is an increasing strain between franchisees and their franchisors. It is no accident that new franchisee associations are being formed and existing organizations are getting more militant. There are many intangible reasons, as too many franchisors do not treat their "z's" as partners. We have written many times that the "asset light", "free cash flow" model is not reflecting the necessary investments in the system to keep franchisees as profitable as possible. Many franchisees are especially bothered by the fact that their franchisors are spending hundreds of millions, sometimes billions, of dollars buying back stock and making acquisitions, while leaving the franchised operators without the necessary new product development, technology upgrades, marketing initiatives, etc.etc.

With all of that in mind, the bottom line is the bottom line. Too many franchisees are suffering financially, under more pressure than ever. The typical franchise royalty is 5%, give or take a point, plus 2%, as an advertising contribution. There are often additional charges, not all that material in and of themselves, but adding to an already large burden. Let's say the franchisee is fortunate enough to be making 17-18% store level EBITDA (and Depreciation is not free cash in the long run). Rebating 7 points out of 17 or 18 points starts to feel like a pretty big load, and there is still local G&A to be carried. Even if store level EBITDA, before royalties, is in the low twenties, 7 points gets to be a bother. Additionally: many franchisees, Dunkin' Donuts and Burger King and Jack in the Box are just a few examples of mature systems where decent money is still being made at the store level because the store leases were signed ten or fifteen years ago, so occupancy expenses are lower than today's economics would allow. That's, of course, why so few new units are being built by many mature franchised systems, especially in the USA. Today's economics do not allow it.

When Ray Kroc started franchising McDonald's restaurants over 60 years ago, the royalty was 1.9%. By the 1960s, franchisors had started charging 2-3%, by the 1970s 3-4%, by the eighties 4-5%, and 5% seems to be the standard today, plus advertising and other fees.

At the same time, there are ***no** material expenses that are lower,* as a percentage of sales, certainly not occupancy expenses or labor, and food costs are unpredictable commodities. The biggest single negative trend, that nobody would debate, is the immense competition that has become commonplace. Even in today's over-stored situation, there are more new stores being built, withing chains, than closing. This competitive pressure has also created the need for far more support from the franchisor, if the increasingly critical public is to be satisfied and the franchisee partner is to succeed. Over the last fifty years, as the franchisor should be providing more support and burdening the franchisee less, the trend has been just the reverse.

The answer: lower fees, especially ongoing royalties.

This specific suggestion will not be adopted by existing large chains, because it would be such an obvious reduction of the current royalty stream. However, well established franchisors could, and should, absorb more of the additional systemwide needs, such as technology upgrades. "Mid-stage" franchising companies could put some part of the following suggestions in place.

If I were running an early stage franchising company, I would put in place a sliding scale royalty system, charging 2.5-3.0% at a modest sales level, higher if the franchisee does better. Give them a little room to make money if the store doesn't do quite as well as everybody hopes. If the store clicks, everybody is happy and 4-5% on the higher sales won't seem like such a burden. For my multi-unit franchisees, I would charge lower up front fees for development of 2nd, 3rd and additional stores, and this is sometimes already being done (whether admitting it to Wall Street or not). This is logical and appropriate, because less franchisor support is required as a franchisee builds local infrastructure.

It seems likely that a young franchising company adopting this strategy would have a huge competitive edge and the total royalty stream is likely to build more rapidly using this progressive approach. Profitable franchisees, and a more appropriate sharing of store level profits in today's economic reality, make for a successful system in the long run.

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