

# Pricing Of Franchises: How to Charge For Fees, Area Development Fees, Etc Establishing Service and Continuing Other Fees

BY: Michael H. Seid, Managing Director, Michael H. Seid & Associates, LLC

## 1. INTRODUCTION

Fees, their determination and management, in a franchise system represent an inherent weakness to the franchising strategy.

### **The business of the Franchisor is inelastic.**

All businesses continually make permanent or temporary adjustments to the selling price they charge to their customers. They alter their products, merchandising or service mix in an effort to improve their financial performance. They work with suppliers to reduce their raw material costs and manage internal expenditures for the same reason. These are standard business strategies.

To a great extent, these strategies are unavailable to franchisors. Once franchise fees, royalty rates, or other fees are established, the franchisor is limited to the adjustments they can make, except with respect to their future franchisees, renewal franchisees or after long and expensive negotiations with their existing franchisees. The same holds true for the services franchisors provide to their franchisees. Many of the services were promised in the sales presentation, are included in the franchise agreements or have become standard in the franchise system. These are equally difficult to change without some disruption to the franchisee/franchisor relationship.

The establishment of fees in franchising is a balancing act. Setting the fees too high leaves little profit for the franchisees, and may make the sale of new franchises difficult. Setting the fees too low leaves the franchisor with insufficient revenue with which to provide the franchisees with the services they require, (and are anticipating based upon the franchise agreements) and leaves the system without the proper resources to continue in operation, expand and earn a proper return.

Often, it is this inelasticity which causes franchisors financial difficulty.

The problem is often compounded because of the methodology used to initially set the fees. Fees often are set simply to ensure they are competitive with other franchisors rather than set at financially justifiable rates to ensure profitability for both the franchisee and the franchisor. New franchisors often place greater emphasis on out-marketing the competition than on ensuring adequate revenue to out-service the competition.

A further problem is that all franchisees are not equal. Typically new franchisees require heightened services than do mature operators. The costs of servicing franchisees in markets which have achieved critical mass is less on a per unit basis than less established markets. Multi-unit franchisees offer the franchisor certain efficiencies which are not present in single unit operators and are therefore less expensive to service. Some markets are simply more financially rewarding because of the volume of transactions in each location is higher than a comparable location in another market. In essence, the higher "profit" franchisees are used to subsidize the higher "cost" franchisees.

Finally, when franchisor's prediction of expansion is excessive or when they underestimate franchisee failure this provides for an unrealistic basis upon which to project future revenue.

In an inelastic "industry" such as franchising, all of these factors make the establishment of uniform, and for the most part, fixed continuing fees problematic.

## 2. TYPES OF FEES

There are many potential sources of revenue available to franchisors. While each franchise system is different, these fees can generally include:

### A. INITIAL FEES

- Deposit agreements
- Investigation or due diligence fees
- Breach of agreement fees
- Franchise fees
- Initial training fees
- Software and hardware income
- Site location and development related fees
- Equipment, initial inventory and materials income
- Promotional materials

### B. CONTINUING FEES

- Royalty
- Training
- Staff Certification
- Field services

Leases and property management  
Equipment and signage rental  
MIS and POS licensing fees  
Shared guarantee and gift certificate programs

C. POST TERM FEES

Renewal  
Transfer  
Assignment  
Public offering related costs

D. ADVERTISING/MARKETING FEES

Initial and continuing national/regional/local fund contribution  
Local store marketing requirements  
Yellow page requirements  
Supplemental contributions

E. PENALTY FEES

Audit costs  
Interest rates  
Loss of Manuals  
Violations of trade secrets  
Management fees  
Administrative fees  
Insurance fees

- F. **HIDDEN FEES** - franchisor profit on direct or indirect sale of inventory, supplies or materials to franchisees or rebates from suppliers.

This last category of fees being less hidden under the new NASAA disclosure requirements.

### **3. METHODS FOR DETERMINING CONTINUING FEES**

As stated above, the determination of continuing fees is a balancing act. The fees must provide for adequate revenue to support the franchisor and at the same time be affordable by the franchisee.

The fees charged to franchisees are a product of the operations of the system at all levels. The determination of the structure and amount of fees should therefore be made as part of a strategic examination of the entire franchise system. This review of franchise fees is only a portion of that strategic examination.

As the future of the franchise system rests with the profitability of its franchisees, the first analysis should be the profiling of franchisee financial performance.

#### **3.1 FRANCHISEE FINANCIAL PROJECTIONS**

Every franchisee assumes that with hard work their investment in a franchise will result in income. Franchisors need to ensure that after paying the system's fee, the remaining income provides for an adequate return for the franchisee. The franchisor

should determine for themselves what a minimum acceptable return for their franchisees should be.

To do this, unit financial modeling is required. While defining a typical or average unit performance will not ensure that the fee structure will be adequate for all franchisees, it is the primary tool available.

Initially, the unit financial models do not include any franchisee system fees. Once the analysis has been completed, an investment analysis is performed to determine the units pre-franchise rate of return.

The difference between the pre-franchisee rate of return and the acceptable rate after fees provides a benchmark for the maximum charges affordable by the franchisee.

The actual fee structure for the franchisee can be made after financial modeling is completed, both for the franchisor and for the franchisee.

### 3.2 FRANCHISOR FINANCIAL MODELING

Financial modeling for franchisors includes an analysis of:

1. Existing system revenue
2. Anticipated system expansion and contraction
3. Examination of franchisor's services to the franchisees
4. Examination of service costs
  
5. Examination of other system costs
6. Examination of systems other financial and capital requirements
7. Determination of acceptable return for franchisor

Once the system costs and existing revenue is modeled, the franchisor can establish the additional income required to meet return their requirements.

In order to establish an acceptable balance between the franchisees return requirements and the franchisors return requirements, multiple financial modeling will be required for both levels until the required balance is achieved.

During this modeling, those services which the franchisor had planned to provide to the franchisee will be further examined for affordability. While every franchisor would like to provide their franchisees with every conceivable service some services are not cost effective for either party. During the modeling process, the final service package will be determined.

Cost centers are segregated into those which are primarily related to initial franchisee services and those primarily related to continuing franchisee services and other overhead.

The rationale for segregating costs is that healthy established franchisors should rely on continuing revenue to support the continuing system and should not need to rely upon initial franchise fees for that purpose.

Therefore, initial franchisee introduction costs (recruiting, training, site selection, site development, initial field services etc. ) should be evaluated in the context of initial fees while the franchisors continual service costs (field services, home office support, research and development, corporate expenses,.etc.) should be evaluated in the context of the continuing fees. This segregation will ensure that the franchisor remains financially healthy regardless of franchise sales.

At this point in the financial modeling the franchisor will be able to determine the gross fees required by the system and affordable by the franchisees. Finally, the franchisor can commence a determination of the financial structure of the continuing fees.

#### **4. THE SUBJECTIVE DETERMINATION**

The most important consideration to make in determining the continual fee structure is subjective. How should the fees be structured so that the total of the fees collected by the franchisor and paid by the franchisee provide a satisfactory return for both.

##### **4.1 USER FEES**

Franchisors examine their continuing services and make a determine of whether certain services should be provided on an ala carte basis with user fees charged. This determination will vary based upon management's franchise system support objectives.

Should ancillary services such as continuing education, additional field support, MIS/POS support and enhancement costs, etc. be included in the royalty or are they treated as user fees?

If they are to be charged separately as user fees, are they to be provided on a cost pass through basis or does the franchisor include a margin of profit into the costs?

Does the franchisor charge for the cost of travel and staff salaries for requested field support? Does the franchisor earn income from the sale of merchandise and supplies to its franchisees? Are rebates from suppliers considered income to the franchisor or are they passed through to the franchisees as either reductions in their cost of goods or

as contributions to their advertising funds?

When the franchisor can identify the cost of a specific event, transaction or service provided to a franchisee, they can then set user fees accordingly. The purpose of the user fees is to compensate the franchisor for specific services used by a franchisees on an as used basis.

Once the determination is made regarding the user fees, the balance of any revenue shortfall will typically be made up from the royalty fees collected.

#### 4.2 BROAD BASED FEES

The purpose of the broad based fees are primarily to:

1. Compensate the franchisor for relinquishing their rights to a market for a defined period of time.
2. Compensate the franchisor for providing the franchisees with the services they require.

It may sound obvious, but the accumulation of all of the continuing fees collected from franchisees, both broad based and user, is the continuing franchisee revenue for the franchisor. While certain fees are more significant and occur with greater frequency, royalties being the primary example, it is the total of these revenue when compared to the total expenditures and required rate of return which is the important driver in establishing a fee structure.

Ultimately, by financially modeling the franchisee and franchisor, and identifying which fees will be user based and which will be included into general services, the rate of

royalty can be calculated.

## **5. METHODS OF DETERMINING ROYALTY FEE STRUCTURE**

Most often franchisors establish their royalty based upon a percentage of the franchisees gross sales. While it is often the simplest fee structure to administer and explain to the franchisees, it is not always the best method to ensure the best balance for either the franchisor or the franchisee.

There are many variations used by franchisors. Some of the more common fee structures include:

### **5.1 FIXED PERCENTAGE OF GROSS SALES**

This is the most common fee structure. The franchisee reports gross sales, after making certain approved adjustments (taxes, bad debts, returns, etc.). The royalty is calculated by applying the fixed percentage to the adjusted gross sales.

### **5.2 VARIABLE PERCENTAGE OF GROSS SALES**

#### **5.2a DECREASING PERCENTAGE - MONTHLY SALES**

This structure is used by some franchisors in the belief that reducing the percentage royalty on increasing sales is fairer to the franchisee as it provides additional reward for superior performance and still provides the franchisor with an acceptable rate of return. Some also feel that the decreasing percentage encourages franchisees to report total

sales more accurately.

The franchisor establishes different royalty rates for various levels of monthly sales. As the monthly sale increase, the royalty rate goes down. The franchisee applies the royalty rate for all sales in the month. In subsequent months, the royalty rate will again be based upon the level of sales achieved.

#### 5.2b DECREASING PERCENTAGE - CUMULATIVE SALES

This royalty structure is similar to above. except the franchisee applies a lowering royalty percentage based upon cumulative annual sales rather than individual monthly sales. The royalty report reflects cumulative sales total, and as the franchisee exceeds the target, the royalty rate drops on future sales until the next sales target is reached.

#### 5.2c INCREASING PERCENTAGE - MONTHLY SALES

All locations and markets are not created equally. The rational for the use of an increasing percentage is to provide the franchisor with additional compensation for granting a market which has superior performance.

#### 5.2d INCREASING PERCENTAGE - CUMULATIVE SALES

This royalty structure is similar to above. The franchisee applies a higher royalty percentage based upon cumulative annual sales.

### 5.3 MINIMUM FEE STRUCTURES

#### 5.3a MINIMUM ROYALTY

The franchisor grants a market with the expectation that the units performance will meet certain minimum expectations. To provide the franchisor with a minimum level of return on the market, regardless of the sales at the location, a minimum fixed royalty is established.

In those periods in which the royalty as a percentage of sales does not meet the minimum royalty, the franchisee remits a minimum royalty fee. Minimum royalty fees are typically adjusted periodically based upon a CPI or other basis.

#### 5.3b CUMULATIVE AVERAGE

Similar to the minimum royalty above, except the franchisees may pay their royalty based upon a rolling average of sales.

Sales in periods which exceed the minimum requirements, may be averaged with sales in periods which did not meet minimum requirements. This method reduces the negative impact felt by franchisees who are required to pay a minimum fee. The periods which may be averaged are typically limited to three months.

#### 5.4 FIXED ROYALTY

The royalty is a fixed fee and is not affected by unit sales. The franchisor is assured of a fixed dollar return each month, while the franchisee receives the full benefit from increased unit sales. The fixed royalty basis is similar to a commercial lease without any sales override. The fixed fee is typically adjusted periodically based upon a CPI or other basis.

## 5.5 START UP PERIOD ADJUSTMENTS

Franchisors recognize that during the initial period of operation, the franchisee may have higher costs in establishing their business and at the same time, lower sales until they reach maturity. To assist their franchisees during this period, some franchisors will eliminate or reduce the royalty rate during the development period. The amount of royalty not collected is either treated as unearned or may be considered as a deferral or loan to be paid at a latter date.

## 5.6 TRANSACTION BASED

Franchisees are charged a fix fee based upon number of units sold, transactions closed, rooms rented, bottles shipped, etc.

## 5.7 NO ROYALTY FEE

In franchise systems in which the franchisor earns income from the sale of merchandise or services to its franchisees, the markup on these sales and services is earned in lieu of royalty.

## 6. ESTABLISHING RETAIL ADVERTISING AND MARKETING FEES

Regardless of the structure a franchisor chooses to administer and expend franchisee marketing contributions, they must be certain that the amount of promotional dollars available is adequate for the purpose. They also must be assured that the level of advertising contribution required of the franchisee is affordable. Just as with other continuing fees, the marketing contributions by franchisees must be balanced.

Franchisors that set fees at unrealistically low rates, in order to be competitive with other franchisors, will soon find that the lack of effective advertising programs will be viewed by the franchisees as a failure of the franchisor. Setting the fees at too high a rate will be unaffordable by the franchisee and will therefore create other problems.

And, just as with the evaluation of other continuing fees, all franchisees and markets are not equal. Unit sales, critical mass, population densities, local media costs and effective marketing methods and availability will vary.

Nor are all franchise systems equal. Large systems have national marketing alternatives which smaller systems do not. Franchisors that have effectively established critical mass have alternatives which other systems do not.

Therefore before establishing advertising and marketing fees, franchisors need to be aware of their retail and marketing positioning. Among a host of considerations they must take into account:

1. What are the effective retail advertising and marketing strategies available today.
2. What are the effective grand opening advertising and marketing strategies available.
3. What strategies are affordable for the system and markets today.
4. With responsible growth expectations, what will be the affordable marketing strategies in the future.

5. How to structure the advertising fees to ensure that the franchisor has the flexibility to meet future requirements.

## 6.1 RETAIL MARKETING EXPENDITURES

### 6.1a GRAND OPENING

The amount the franchisee is required to expend on Grand Opening marketing is usually stated in the franchise agreement. The methods for implementing the grand opening program will vary, from general guidelines established by the franchisor and provided to the franchisees for their implementation, to a program planned and implemented directly by the franchisor for the new franchisee.

Regardless of the approach taken , the general range of minimum costs for the grand opening program can be estimated by the franchisor.

While the minimum level of grand opening costs are specified in the franchise agreements, the franchisee always has the option to expend more. And in established markets, the grand opening campaign can often include support advertising from the other franchisees.

There are generally two methods franchisors utilize to manage the grand opening expenditures:

1. The franchisee pays for the cost of the program directly.
2. The franchisee contributes the required amount to a designated fund or

cooperative.

In some franchise systems, in addition to the grand opening expenditure, the franchisee is required to make an additional contribution to a designated fund or cooperative. The purpose of this contribution is to effectively compensate existing franchisees in the market for developing the market prior to the franchisees entrance.

#### 6.1b LOCAL MARKETING

Most franchisors have some requirement for franchisees to advertise locally. The amount required is often set as a fixed dollar amount, a minimum dollar expenditure vs a stated percentage of gross sales or simply as a percentage of sales.

Often franchisors will state the local marketing requirement as a range which can be adjusted over time. The reason for establishing the local marketing contribution as a range is to provide for future changes to the franchisor's local marketing strategy as well as to provide for changes in market dynamics and costs.

#### 6.1c YELLOW PAGE ADVERTISING

The requirement to advertise in the franchisees local yellow pages is often specified separately.

The determination whether to credit the cost of the yellow page advertising to the franchisees minimum local marketing requirement, or to specify that it is in addition to the local marketing requirement varies among franchise systems.

#### 6.1d LOCAL AND REGIONAL COOPERATIVE PROGRAMS

The use of advertising cooperatives by franchisors is growing. These are marketing funds which the franchisees typically have a greater level of control than they do over national fund contributions.

Even in franchise systems which have not established cooperatives, it is not uncommon for the franchisor to provide for the right of the system to establish the cooperatives in the future. In those situations, the local franchisees will be required to participate in the cooperative when they are established.

The amount of the franchisees contribution to the cooperative is usually stated as a minimum vs a percentage of gross sales. In some systems the amount of fund contribution may be stated as a fixed dollar amount, typically with an annual CPI adjustment.

As with yellow page advertising the contribution can either be credited against the local minimum marketing requirement or as an additional expense for the franchisee.

#### 6.1e NATIONAL FUND CONTRIBUTIONS

There are very few franchisors who have not established a provision in their franchise agreements for a national advertising fund.

As with other marketing expenditures, these can either be a fixed dollar amount (with annual CPI adjustments), minimum dollar amount vs a percentage of sales or simply as a percentage of sales.

Most franchisors attempt to spend their franchisee's fund contributions in their markets

even when it is not provided for by the franchise agreements. The reasoning for providing the option to expend money outside of the contributing market are:

1. Strategic - Some markets may require more advertising expenditures than can be afforded by the local franchisees. It is in the systems interest to provide this additional support by taking money from other markets.
2. National and regional advertising requirements.

Some franchisors, even though not required by the franchise agreement, will manage the national funds, internally, on a market basis. They will treat advertising advances to markets, in excess of the markets contributions as inter-market loans.

#### 6.1d SUPPLEMENTAL ADVERTISING CONTRIBUTIONS

Franchisors often specify minimum advertising weight by market. This is to ensure that marketing dollars are spent effectively.

In situations when the available fund balance does not enable advertising at this minimum weight franchisors may decide not to expend any of the fund balance until the minimum dollars are available in the local market.

In some systems, the franchisor may lend money, from their operating accounts to the fund or may contribute the money. In other system, the franchisor may give the franchisees the option to make supplemental contributions to provide for the additional dollars. In those systems, it is usually provided that when a majority of franchisees in the market agree to the supplemental contributions, the other franchisees are obligated to do so also.

## 7. FREQUENCY OF COLLECTION

Typically, royalties and advertising are collected on a weekly, bi-monthly or monthly basis, although there are still a few franchisors that collect their fees on an annual basis.

The majority of franchisors, especially those whose franchisees have considerable capital invested in fixed assets, have elected a monthly basis.

Franchisors need to examine the cost benefit relationship of requiring frequent franchisee remittances vs. working capital benefits. While it is certainly feasible with electronic transfer to collect fees, even on a daily basis, the transaction costs can be prohibitive. Many franchisors who examine the cost of collecting fees on a frequent basis discover that the cost, both for the franchisee and the franchisor in administrative, banking, bookkeeping, lost management time and opportunity costs, make the cost of improved cash flow an illusionary benefit for the system.