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SETTING FEES IN INTERNATIONAL FRANCHISE AGREEMENTS

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1. Introduction

Typically, business people with ambitions to franchise their business begin by developing their idea in their local market. They develop a business model which reflects their products, pricing and marketing concepts and plans. The model is built to meet the needs and wants of their target market. If the model takes hold, then they begin to expand regionally by locating others to operate franchises that practice the business model in new markets. If these ideas work well in the broader market, then the franchisor has the opportunity to grow nationwide. If successful, the business expands to reach a significant portion of the nation's population and the brand becomes well known to a significant portion of the citizenry. This progression from local to regional to national benefits both the franchisor and franchisee. Both gain from economies of scale in terms of their ability to acquire the inputs to the franchise operation and their ability to leverage mass media outlets to gain more customers.

For many franchisors, the next logical step is to go international. While going international can be viewed as just one more logical step to a growing franchise, it is a much bigger step than many imagine. Moving to a new international market means transplanting a successful business model in one country and culture into another country and another culture. Often, there are obvious changes and accommodations that must be made in the business model to adapt to the new nation. Simple examples include not serving beef or pork to accommodate local customs or varying business hours to comply with local regulations. But, just as often there are many not so obvious changes and adaptations that must be made to ensure success in new international markets. For this reason, as well as several other reasons, franchisors with international ambitions often seek a partner in the international market to help develop the concept and brand in the new market. Most often, this takes the form of master franchise arrangements, whereby the local master franchisee sub-franchises to unit franchisees and plays the role of franchisor in that country or area. Less often, the foreign expansion of a franchise system takes the form of the franchisor granting unit franchises directly to unit franchisees in the particular country. Of course, there are also hybrid versions of these arrangements as well.

Because of their frequency of use in international franchise expansions, this paper will deal mostly with the master franchise model. Fees play an important role in the relationship between the original franchisor and the master franchisee in the new market. There are many fees that need to be addressed in international franchise agreements, such as fees for renewal, transfer, advertising fund contributions, training and retraining, software licenses, etc. However, important as these fees are, the greatest challenges arise when setting the initial fees for the rights granted and the royalty fees to be charged to the unit franchisees and how the royalties will be shared between the franchisor and the master franchisee. So, it is these fees that will be the focus of this paper.

Typically, a master or area franchisee pays an initial franchise fee to acquire knowledge and expertise about the business model and to receive the right to develop the business in the new market. This fee represents a return on the original investments made by the franchisor to develop the business model and a recovery of direct costs incurred by the franchisor in sourcing and setting up the master or area franchisee. To make the expansion successful, there must be good value on both sides of the equation. Too high a fee limits international expansion possibilities by setting up a financial barrier, thus limiting the size of the pool of potential international partners. Too a low of a fee provides insufficient compensation for the use of the business model and in the worst case scenario may not offset the franchisor's costs.

Additionally, while the dollar amount of the fee is important, the structure of the fee arrangement is important too. For example, should the fee be a large upfront amount paid on signing or should part of the entire fee be linked to the performance? Since upfront fees reduce risks for the franchisor and increase risk for the international franchisee, the structure of the fee affects the behavior of both the franchisor and the international franchisee. Therefore, getting the fee and the structure associated with the fee right is critically important to the success of the international expansion.

Another important aspect of getting the international franchise fee "right" is understanding the expectations of potential franchisors and master franchisees. These expectations shape the opinions of potential international franchisors and their counterparties. Therefore, before embarking upon a discussion of international franchise fees, it is important to begin by exploring other types of investments and their returns available to potential participants.

2. Investor Expectations

Modern financial theory indicates that risk and return are intertwined. If one wants to determine the appropriate return for an investment, one needs to understand the risks associated with that investment. Similarly, if one wants to evaluate the risks related to an investment, one needs to understand the investments expected return. In other words, it is difficult to evaluate risk and return independently. This relationship complicates discussions of expected return from an investment because it requires us to address the risks. Understanding the risk of an investment can be difficult because risk can be hard to quantify. For example, it is difficult to estimate the risk of owning an apartment building or buying a business. Often the risks are somewhat subjective and depend upon one's view of future economic conditions.[1]

One way to evaluate returns from an investment opportunity without directly quantifying risk is to compare the expected returns from the opportunity to the returns from other investments. If one can find an alternative investment that has risks that are similar to the opportunity, then one can determine if the opportunity provides enough return. For example, if one is offered an opportunity to invest in an apartment building that returns 10% and knows that real estate investments historically have returned 8%, then it is

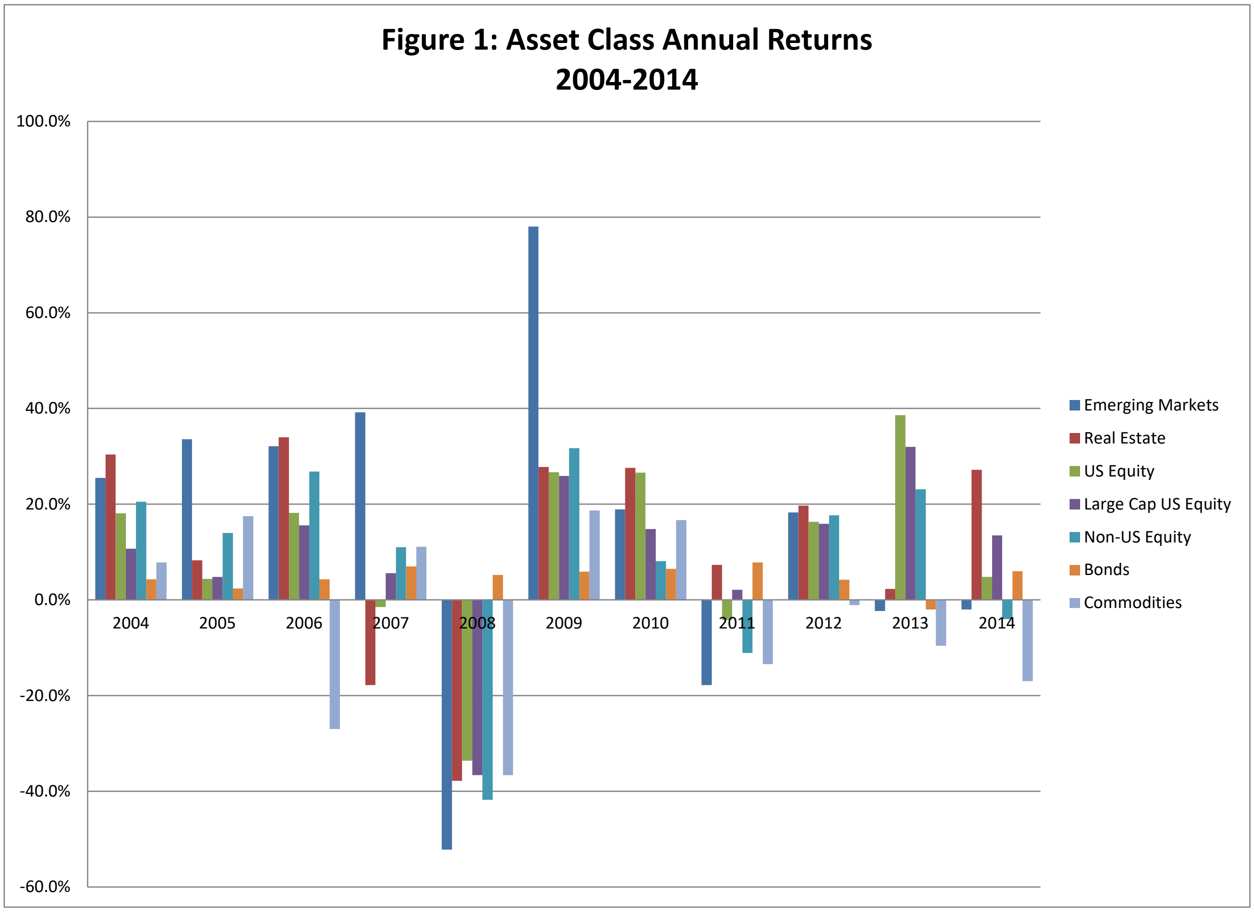
[1] Financial economists define risk in terms of variability of return and risk of failure. This definition of risk works well for modeling economic choices, but is too abstract for our current discussion.

reasonable to conclude that there is evidence the apartment building opportunity provides a good return.

When a franchisor is evaluating the decision to take his business into an international market, he should form some expectation of the expected return from the move and compare these returns against other alternatives. Similarly, when the prospective international franchisee is evaluating the business opportunity, he should consider his alternatives as part of his decision making. Therefore, before we discuss the specifics of setting international franchise fees, which establish the returns from going international, it is helpful to provide a little background information on returns from alternative investments.

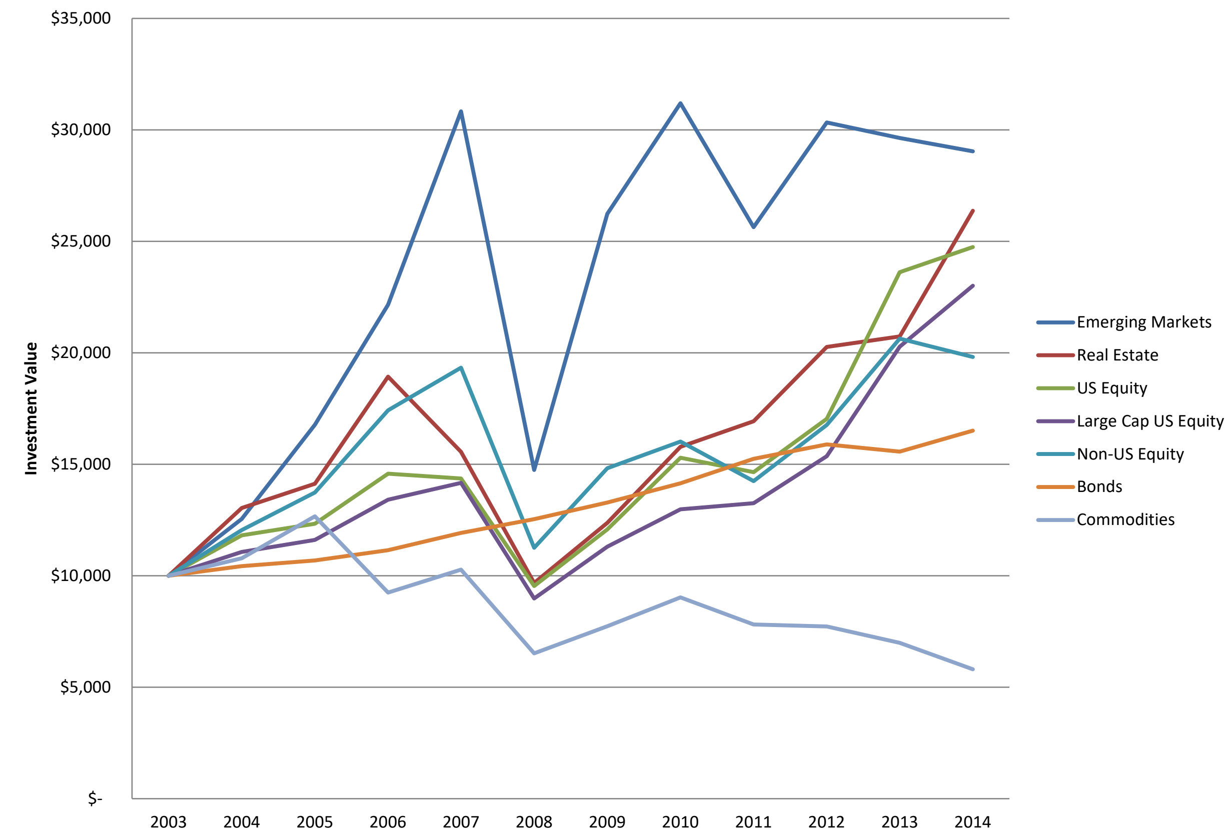
Over the last ten years, the returns from various asset classes have been volatile. Much of the volatility is driven by the Great Recession of 2008. The recession caused almost all financial assets to decline in value. Fortunately the declines during the recession were followed by significant gains. These gains reflect the overall strength of world markets and are an encouraging signal about our economic future. Figure 1 below shows annual returns for seven financial asset baskets. Annual returns from emerging markets, non-US markets, US markets and large capitalization US firms are listed along with returns from bonds, real estate, and commodities.[2] Figure 1 shows the large variations in returns for the various asset classes and their variation over time.

[2] Emerging markets are represented by MSCI Emerging Markets Index, Real estate by REIT Index, US Equity by Russell 2000 index, Large Cap US Equity by S&P 500 index, Non-US Equity by MSCI EAFE index, Bonds by Barclays Aggregate Bond index and Commodities by Bloomberg Commodities index.



To form an idea of what potential investors may expect in terms of return over a long time horizon, we can compute the value of a $10,000 investment made in the beginning of 2004 in each of the seven asset classes. This hypothetical investment grows over time based upon the returns shown in Figure 1. As shown below in Figure 2, a $10,000 investment in the beginning of 2004 would have grown into just under $30,000 if it were invested in the world's emerging markets. Figure 2 also shows that such an investment would have varied wildly in value during the ten year time horizon. One can contrast the investment in emerging markets with an investment in bonds. Figure 2 shows that a $10,000 investment in bonds in the beginning of 2004 would have grown into $16,500 over the ten year time horizon. While this is significantly less than the value of the emerging markets investment, notice that the bond investment grew steadily over the horizon and did not decrease significantly in value during the Great Recession.

Figure 2: Value of Hypothetical $10,000 Investment After 10 Years



Pulling this information together, we can get an idea of the return for various asset classes. Table 1 below summarizes Figure 1 and 2 by calculating the average annual return for each asset class over the ten year time horizon.

Table 1

Asset Class	10-yr Annual Return
Emerging Markets	8.8%
Real Estate	7.3%
US Equity	7.7%
Large Cap US Equity	7.6%
Non-US Equity	5.2%
Bonds	4.7%
Commodities	-3.3%

Table 1 indicates that potential investors may likely expect annual returns of between 5 and 8 percent over the long term but that actual short term returns may vary by a wide margin.

3. Impact on Valuing Existing Franchise Company

It has been clearly demonstrated, year after year, that the public markets have an appetite for franchise companies. A more recent phenomenon is that the private equity funds, which are awash with cash, have caught the franchise fever. For them, the purchase of the **right** franchise system presents a wonderful opportunity for leveraging their cash, within a reasonable horizon, often less than 7 years, to show a fabulous return, i.e. 20 times invested cash or more.

The impact of an international franchise expansion on the attractiveness of a franchise company as a target for acquisition is a mixed bag. Certainly, any expected increase in cash flow, will have a positive impact. And there are other positives, such as the caché of being an international franchisor, the wider recognition of the system brand and the establishment of a base and expertise for future international growth. However, the expected increase in cash flow may be accompanied with increases in the variability of cash flows and the possibility in decreases in cash flow due to improperly established international franchise fees and fee splits.

Another factor in this valuation exercise is the ability of the franchisor entity to alter (increase) fees or fee splits in the future or the ability to charge new fees, i.e. for renewals. Specific language in franchise agreements is critical, as well as the length of initial terms and the number and length of renewal terms.

4. The Initial Franchise Fee

At the level of an international master franchise or area development deal, for the franchisee investor, return on cash and capital appreciation are very important. However, anyone experienced in this area will tell you that the decision to invest in the franchise opportunity is often a decision made with a heavy emotional component; the investor likes/loves the concept, feels pride in importing a brand from another country and/or sees personal benefits in bringing opportunities to others in their country.

Unfortunately, other than the experience of those who have done a number of these deals, there is very little to no reliable statistical data about “market” rates for fees in international franchise agreements. This is not surprising, given the number of potential and very diverse markets, franchise systems and industries which would need to be analyzed.

These fees will be influenced by many factors, including the length of the term of the grant, the history of success of the franchise system, the amount of training and initial support to be provided by the franchisor and the level of additional investment required of the franchisee. Drawing analogies to other existing systems, with such franchise structures, can be helpful in deciding upon the amount to charge or pay, but it is best to relate the fee to the potential for profit and return on capital of both parties. In one survey[3], of the master franchisees studied, 36% invested $100,000 to $250,000, 28%

[3] From a 2000 survey of master franchisees by John P. Hayes, Ph.D, Hayes/Worldwide

invested less than $100,000, 21% invested $250,000 to $500,000 and 17% invested more than $500,000.

Many of the franchisor's issues are just the flip side of the franchisee's issues. However, one of the most common mistakes made by franchisors in this area is to set the fees too low. One way to alleviate this problem is to set a minimum amount and calculate the final fee based upon the performance of the franchisee, either by number of units opened or percentage of sales or some other basis that increases the front-end fee as the system is expanded within the territory. On the other hand, franchisees often pay too much for such fees upfront, which can drain the master franchisee of much needed capital during the critical early stages of development of the territory. For the franchisee, the best approach is to fix the amount of the initial franchise fee, but have its payment dependent upon the number of franchises opened over an extended period of time. However, this approach may not be palatable for franchisors of service businesses, because of the fear that, once the know-how is passed on to the master franchisee, the master may default and eventually start to compete.

At a minimum, most franchisors would want to set the initial franchise fee to at least recover its costs for establishing the franchise in the foreign country. Such costs could include at least the following:

- Researching the market (Commercial, legal and logistics)
- Preparing country entry business plan
- Adapting the brand, operational methodologies, products etc to suit the local market
- Marketing and Sourcing the potential franchisee
- Researching the franchisee's background and credentials
- Regulatory compliance
- Creation of local franchise documentation
- Taking steps to protect the system intellectual property
- Setting up supply chains, Addressing all product labeling and logistics of importation of products and material
- Identify a degree of price parity
- Supporting local candidate to meet local legislative and regulatory requirements
- Translating operating manuals
- Customizing marketing material

- Travel
- Training
- Secondment of staff
- Overviewing the franchisee business launch development schedule

From that point forward the task becomes more complex. The franchisor may very well want to and be justified in adding to those costs a “goodwill” value for the use of the brand name and/or an “opportunity” value. The “opportunity” value, for want of a better definition, would be some value for the fact that the franchisee will be able to earn a significant return on its investment (if that is the case) simply by implementing the franchise expansion in the foreign country. This value will vary country to country depending upon the potential for development of the system in each country. A Franchisor will normally look to recoup its standard IRR (internal Rate of Return) on any investment it would customarily make if it had decided not to use the capital to franchise in that market.

A franchisee may also look at the time it takes to recoup the initial franchise fee in its evaluation of the offering. A 2 year pay back is terrific and a 5 year pay back is often acceptable. Some of the variables are the amount of the fee, the length of the term granted and the amount of additional investment required.

5. Dividing the Spoils

Without a doubt, the most poorly handled issue in master franchising is the division of the front-end franchisee fees and continuing royalty fees, for the unit franchises in the territory, between the franchisor and the master franchisee. These amounts are usually set by the franchisor and are often the principal, if not only, source of profit for the master franchisee and the franchisor in the foreign country. It is not unusual for the franchisor to base its decision on the allocation of these fees on its anticipated or desired return from the development of the system in the territory without serious or careful regard for how the master franchisee will finance the necessary development and support services for the unit franchisees. Mistakes with this issue will either ensure the demise of the master franchisee or reduce the quality and performance of the system in the territory.

For example, if the continuing royalty is set at 6% of gross revenue of the unit franchisee and the franchisor decides it is entitled to 3%, when it costs 3% to do a proper job of developing and supporting the system in the territory, the master franchisee is faced with either making no profit on royalties or reducing the level of support to the unit franchisees. If, however, the franchisor keeps some of the responsibilities for administering the system, such as field support, training or supply chain management, the 50-50 split on royalties might work. The problem is even more apparent in the division of the initial unit franchise fees. Such fees are often, at best, compensatory to the master franchisee for the costs of properly setting up the unit franchisees. Therefore, where the master franchisee assumes all of the responsibility and expense for establishing the unit franchises, but the franchisor takes a percentage of the initial franchise fee, something has to be compromised. The point is that the responsibilities for the development and administration of the system should be decided first as between the franchisor and master franchisee. Then the division of the various fees should be based upon the costs of discharging those responsibilities and only after that should the parties divide up the remaining “profits”.

6. Unit Economics

The starting point for any effort to establish fees in international franchise agreements should be the financial projections for the unit franchisees. If fees are set at levels that are too high for unit franchisees to be appropriately profitable, then the system will fail in that country and the franchisor may find itself enmeshed in litigation with the master franchisee or even unit franchisees. If fees are set too low, then the franchisor is not only missing out on greater financial rewards for its efforts and the use of its valuable intellectual property, but the chances of finding and motivating a quality master franchisee are more limited.

Getting closer to the “sweet spot” on fees for any particular country is solely dependent upon the amount and quality of the research done by the franchisor. And this means securing accurate information about every conceivable aspect of how the unit franchisees will be able to operate successfully in the foreign country. While the experience of the franchisor in its home country will be the logical starting point, it will be important to test all assumptions against the realities of the foreign jurisdiction, including cultural differences, labor costs, supply costs, buying habits, etc. Done thoroughly and correctly, this will inform the franchisor about the potential financial returns from the operation of the system in the foreign country, regardless of who plays the role of the franchisor.

From there, it is best for the franchisor to investigate what the full costs will be for a master franchisee to operate the franchise system in the foreign country. There are many variables which could make it a very different proposition than is the case in the home country; franchise sales commissions could be different, the time it takes to close deals might be longer, geography or infrastructure challenges might increase the cost of field supervision and the supply chain and labor costs and effectiveness might be a factor.

Once these investigations are complete, and the financial model for sub franchisees, master franchisee and the franchisor are prepared (ideally localized with the help of local advisors, to take into account any variables) the franchisor will have a picture of what fees are sustainable and, accordingly, what gross revenue might be available for division between the franchisor and the master franchisee.

7. Drafting for Flexibility

Where it is palatable to the parties, there are many possibilities to draft contractual language in order to bridge any uncertainties about fees in an international franchise agreement. This could allow fees to increase from artificially low figures or decrease from particularly high figures. The only limit is the imagination of the drafter.

Some examples are:

- Tying the initial franchise fee to the number of units actually sold and opened within a given period of time
- Tying the initial franchise fee to the amount of revenue generated from the system within a given period of time
- Creating a shorter initial term, with a number of renewal terms, at the option of the franchisee, and the right of the franchisor to charge renewal fees in amounts that take into consideration additional value for the grant
- Setting royalty rates that are variable (increasing or decreasing) based on any number of criteria or thresholds
- Setting fees based on actual results from test units, by formula or otherwise

8. How the World Really Works

Franchise systems are operated by people and people have their strengths, weaknesses and failings. The result is that sometimes mistakes are made, opportunities are missed or success just seems to happen. In international franchising, just as with domestic franchising, a check and a warm body are sometimes all it takes to seal the deal. Certainly, after the fact, the failure of an international franchise expansion has been seen many times to have resulted from inadequate or no research or from horribly mistaken assumptions made about the foreign country, based upon the experiences of the franchisor in its home jurisdiction.

The chances of success in an international franchise expansion rise dramatically, when the franchisor takes the time to investigate the target country thoroughly and analyze the findings well. Nowhere in the process is this truer than in the determination of the fees to charge in an international franchise agreement.