Setting Fees in International Franchise Agreements

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Introduction

• What is more important in franchising than fees? Initial, royalty, transfer, renewal, training, advertising, etc.
• Getting it right: the difference between success and failure or worse, mediocrity
• Amount and division among stakeholders is critical
• Focus will be on master franchising
How Are Fees Usually Set?

• SWAG
• What the franchisor wants out of the territory
• Perceived market rates
• Return on investment for the franchisor
• Return on investment for the franchisee(s)
What is Usually Considered?

- Rarely a comparison to other investments
- Often not what the true costs are to the franchisor – set up and running
- Often not what the true costs are to the franchisee(s) - set up and running
- Most often comparison to other systems
Focus of this Session

• Master franchising
• Initial franchise fees – master and unit
• Royalties
• Sharing of fees between franchisor and master
The Challenges

• NO DATA
• Emotion – franchisor & franchisee
A Rational Approach

• What’s it worth?
• Franchise fees drive returns
• Risk vs. Return
• Role of alternative investments
• Fee structure is important
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## Frame of Reference for Returns

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>10-yr Annual Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Emerging Markets</td>
<td>8.8%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>7.3%</td>
</tr>
<tr>
<td>US Equity</td>
<td>7.7%</td>
</tr>
<tr>
<td>Large Cap US Equity</td>
<td>7.6%</td>
</tr>
<tr>
<td>Non-US Equity</td>
<td>5.2%</td>
</tr>
<tr>
<td>Bonds</td>
<td>4.7%</td>
</tr>
<tr>
<td>Commodities</td>
<td>-3.3%</td>
</tr>
</tbody>
</table>
A Rational Approach

- What’s it worth?
- Franchise fees drive returns
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- Fee structure is important
Fee Structure is Important

• Lump sums vs. running royalties
• Percentage of sales vs. per unit
• Fee structure:
  – Shifts risks
  – Changes behavior
  – Affects returns
## Fee Structure is Important

<table>
<thead>
<tr>
<th>Franchise Royalty on Sales</th>
<th>10%</th>
<th>10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$100.00</td>
<td>$106.00</td>
</tr>
<tr>
<td>Cost of Goods Sold</td>
<td>60.00</td>
<td>66.00</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>$40.00</td>
<td>$40.00</td>
</tr>
<tr>
<td>Franchise Fee</td>
<td>10.00</td>
<td>10.60</td>
</tr>
<tr>
<td>SG&amp;A</td>
<td>20.00</td>
<td>20.00</td>
</tr>
<tr>
<td>EBIT</td>
<td>$10.00</td>
<td>$9.40</td>
</tr>
</tbody>
</table>

Decrease in profits due to royalty 6.0%
The Mistakes

• Initial Franchise Fee
  – Too high or too low
• Dividing the Spoils
  – Sometimes the math just doesn’t work
• Term
  – Too long or too short
The Sensible Approach

• The Initial Franchise Fee
  – KEY Influencing factors: Amortization of Franchisor’s franchise set up costs, Franchisee identification marketing costs, length of franchise term, system track record both domestically and internationally, system adaptation costs, amount of training and initial support, Franchisee estimated ROIC, perceived market potential and future trends, market receptivity, brand recognition, development schedule.
Cost Recovery on Franchise Fee

- 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
The Goodwill Component

• Opportunity value
• Unrelated to costs
• Based primarily on potential franchise return in the particular country
Unit Economics

• The starting point
• Must be based on solid local knowledge
• Test assumptions from home or other territories
• Consider impact of necessary adaptations
Costs of Operating for the Master

• Assumptions about operating costs based on home territory can be dangerous

• Geography, cultural differences, business attitudes, marketing costs and more can change the Master’s results dramatically
Reality

• There is no correct and scientific way to calculate Franchise fees but there is a Right Way for you, if you take note of the above considerations.

• Most importantly, remember the ultimate fee levels and structure have to make the venture financially viable for both parties.
How the World Really Works

• Let’s hear from someone with lots of experience about how he meets these challenges.
Your Turn
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