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Pricing Right for Global Master Franchising

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- What we will discuss:
  - Economic factors used by franchisors to set fees and to determine whether and where to franchise internationally
  - Costs incurred by franchisors and master franchisees in launching a master franchise in a new country market
  - How franchisors set initial fees
  - Approaches to setting ongoing fees and how fees from unit franchisees are shared by franchisors and master franchisees
  - Sources of information to use in setting fees

- What do franchisors charge for international master franchise rights?

  36% paid $100,000 to $250,000

  28% paid less than $100,000

  21% paid $250,000 to $500,000

  17% paid more than $500,000

  - $75,000 to more than $1 million -

  From 2001 survey by John P. Hayes, PhD

- What is the size of the fees your franchisors have charged?
- Is the difference principally based upon the size of the territory?
- Do you know what the marginal cost of granting each franchise has been?
- Do you know how long it has taken to recover those marginal costs as well as other fixed costs associated with international development?

These principles should guide franchisors in their master franchising pricing discussions.

- Principle 1
- A rational pricing model should:
- 1. Enable a franchisor to know whether it will recover its costs of a master franchise transaction through initial fees, and if not, when those costs will be recovered;
- 2. Set a fee which the master franchisee can reasonably absorb through the start up of the business, without overwhelming the business; and
- 3. Avoid surprises and unrealistic expectations, while allowing expansion of the brand with a minimum of risk.

- Principle 2
- Fee benchmarks are only a small part of the input as to what an initial master franchise fee should be.

- Principle 3

  Rational Initial Fees Should:
- 1. Permit a franchisor to recover its costs of granting and launching a master franchise over an acceptable time period.
- 2. Not unreasonably deplete the cash a master franchisee needs to successfully launch a master franchise business in its territory;

(Principle 3 continued)

- 3. Maximize the franchisor's opportunity for appropriate returns over a horizon agreed upon by the franchisor's owners; and
- 4. Be competitive when evaluated as a component of the master franchisee's initial investment. Comparisons must be made on "apples to apples" basis.

- The rational pricing model requires the franchisor to know:
- 1. Its cost of launching a new master franchised business;
- 2. The master franchisee's cost of launching a new master franchise business; and
- 3. Prices charged or initial investment required by "competing" franchisors.

- As more countries adopt franchise disclosure and registration laws, the need to have fees set before approaching a market will become more important.

- Countries With Franchise Disclosure and/or Registration Requirements:

Australia	Japan
Brazil	Korea
Canada	Malaysia
China	Romania
France	Spain
Indonesia	Taiwan
Italy	USA

What are the costs of granting a master franchise in a new country?

- Transaction costs
- Translation costs
- Assistance/support costs
- Opportunity costs
- Goodwill
- Profit

Transaction Costs:

- International Legal Documents Prototypes
  - Master Franchise Agreement
  - Area Development Agreement
  - Unit Franchise Agreement
  - Disclosure Documents
- Manuals
- Marketing and promotional programs and materials
- Sales commissions and travel expenses
- Analysis of legal and practical issues in market by local counsel

(Transaction Costs Continued)

- Drafting agreements and disclosures by franchise counsel for specific transaction
- Negotiation of master franchise agreement, franchise agreement and other agreements with aid of local counsel
- Franchise registration
- Local government approval
- Trademark registration
- Candidate due diligence
- Market research
- Local consultants

Translation Costs:

- Unit agreements
- Advertising and marketing
- Manuals
- Operating procedures
- Recruiting materials
- Equipment
- MIS
- Currency risks

Assistance/Support

- Classroom training
- On-site training
- On-site refinement of concept
- Pre-opening assistance - prototype
- Pre-opening assistance - franchise recruiting and selling
- Supply and inventory sourcing and approval

Opportunity Costs

- Use of staff and finances which may be more productive elsewhere
- Exclusive commitment to performance targets of the selected master franchisee

Goodwill

- Value above fair market value of services and products provided to master franchisee
- Usually reflected in franchise trademarks and service marks
- Measure by reference to:
- Franchise fees paid in domestic market
- Franchise fees paid in international markets
- Franchise fees charged by competitors in local market

Profit

- The right to a fair return on investment made, which is appropriate for risk of the investment.

- Costs are determined by the market, *e.g.* Canada versus China.

- How much of these costs should be included in the master franchise fee?

- How much of the translation costs should be paid directly by the master franchisee?

- Should it depend on the market or the financial capacity of the franchisee?

- Master franchisee initial costs:
  - Travel and Franchisor Due Diligence
  - Legal fees
  - Business plan
  - Market research
  - Initial fees
  - Financing costs
  - Training and related travel
  - Real property acquisition
  - Construction
  - Equipment

(Master franchisee initial costs continued)

- Licenses, permits and insurance
- Advertising and promotion
- Information technology and training
- Prototype unit staff recruiting and training
- Translation of all required documents and materials
- Franchisee recruiting, site selection and training
- Grand opening promotion and support for new franchisees
- Franchisee support
- Travel to franchise conventions/meetings

- Should a franchisor finance part of the initial fee to help the master franchisee with cash flow in the start up phase?

- Should the franchisor keep the fee low, and charge for services as the master franchisee requests them, *e.g.*, training or site visits?

- Should franchisors consider lowering initial fees and charge higher ongoing fees?

- When setting an asking price for an initial fee, how do you find out what competitors are charging?

- How do your franchisors set initial fees?
- How are they adjusted by market?
- What is the most common objection raised by prospects and how have you responded?
- Have you financed the initial fee to accommodate the master franchisee's cash flow?

- What methods of setting ongoing franchise fees are used?
  - Fixed periodic fee based on territory/ units/ schedule?
  - Higher of periodic minimum fee or royalty percentage?
  - Escalating fixed fees
  - Based on master franchisees' gross receipts
    - from initial fees and royalties
    - all ongoing fees
    - all sales
    - variable rate based on item sold or income category, *e.g.*, product sales, royalties, other services

- Minimum fee per unit
  - Actually open
  - Required to be open
- Based upon:
  - Minimum return needed
  - Perceived value

- Issues:
  - Allocation may be motivated by tax concerns
  - Minimum percentage fee of each unit's gross sales (v. receipts), regardless of fees a master franchisee collects
  - Different fees for master franchisee-owned units

- Which fee arrangements have your franchisors used?
- What are the advantages and disadvantages?
- How does one analyze the franchisor-master franchisee split to make sure it is fair to both parties?

- If a franchisor provides training, franchise and other sales support services early in the life of the master franchise, should fees be adjusted once the master franchisee assumes all obligations to its unit franchisees?

- What resources do you use to evaluate the market potential and fees in a new country?
  - GNP
  - GDP
  - CIA Fact Book
  - Economist Country Reports
  - U.S. Commercial Services
  - Local trade associations
  - Success of competing concepts
  - Similarities to domestic market

(Resources continued)

- Political/economic stability
- USA Patriot Act issues
- Tax
- Legal
- Profit repatriation
- Labor, materials, maintenance costs
- Transportation
- Business license requirements

- What are the top problems you have witnessed when Americans have brought master franchises to your country?
  - "Pricing. Singapore is relatively expensive in terms of real estate rentals and labor costs. So, ROI may not be too attractive if the franchise fee is high.
  - "Franchisors should send the best people here during the initial phase to ensure smooth operation if possible, ensure that the franchisee does not have a cash-flow problem. Like anywhere else, it takes at least a year for a new operation to find its feet and gain a genuine following."—Albert Kong, , Managing Director, Asiawide Franchise Consulting, Singapore.

(Top problems continued)

- "Most master franchise agreements offer quarterly visits, and if the master franchisee needs more visits, then he shoulders the cost. More often than not master franchisees will accept the quarterly visit as enough because they don't want to pay any more fees. Proactive support is crucial during the first year, the time when the franchise concept/model is introduced to the Philippines, and there will be concerns and setbacks as one phases in the new concept.
- Considering that franchisors have costs to consider, maybe costs to give full support, particularly during the first year should be part of the master franchise fee, rather than a separate cost to the master franchisee.—Erlinda Bartolome, Managing Director, GMB Franchise Consultants, Manila, Philippines.

- CONCLUSION:
- A rational pricing model for international master franchising will anticipate costs of both the franchisor and the master franchisee and strive to set up the basis for a win-win relationship over time. Intelligent franchisors must look beyond benchmarks to determine whether they can satisfy those objectives in any particular market with any particular candidate.