The Basics of International Master Franchising
February 10, 2008
10:30am - 12:00 noon

Moderated by:
Carl E. Zwisler
Haynes and Boone, LLP

Panelists:

Peter D. Holt
Chief Operating Officer
Tasti-D-Lite, LLC

Amir Kremar
Director of Operations
Applebees International, Inc.
Objectives

• To understand why franchisors use master franchising
• To identify advantages and disadvantages of master franchising
• To understand markets which make sense for master franchising
• To learn how to recruit qualified master franchisee Candidates
• To identify common problems which must be addressed in successful master franchise programs
Facts About
MASTER FRANCHISING

Of 7,500 master franchisees worldwide
3,200 of franchisors offer
master franchises

From 2006 survey by Franchise International Magazine
• Overseas, 80% of U.S. franchisor expansion is through master franchising
• The number of franchisors offering master franchises and area development franchises doubled between 2001 and 2006
Master franchisee survey

- To acquire master franchise rights,
  - 36% invested $100,000 to $250,000
  - 28% invested less than $100,000
  - 21% invested $250,000 to $500,000
  - 17% invested more than $500,000

From 2000 survey of master franchisees by John P. Hayes, Ph.D., Hayes/Worldwide
How successful is international master franchising?

– 30% want to buy another master franchise

• John P. Hayes, Ph.D. 2000 Survey of 2,000 master franchisees
How successful is international master franchising?

• Arturs Kalnins, Ph.D. 2005 Study of 142 restaurant master franchisees:
  – Only 55 were in business at the end of the development term
  – 21 master franchisees did not open a single unit
  – 6 master franchisees met or exceeded their development commitments
Franchising Formats Distinguished

Area Development Franchising

Franchisor grants ↓

Area Developer territory

Franchise Unit 1
By January 1, 2008

Franchise Unit 2
By July 1, 2009

Franchise Unit 3
By January 1, 2010
Area development agreement provides:

- Develop three units during next 12 months
- Sign a unit franchise agreement for each
What is a master franchise?

- Franchisor grants
- Master franchisee (subfranchisor) the right to sell
- Unit franchises (subfranchises)
- Within a defined territory
- Usually at a rate set by a development schedule during a defined period of time
A three-party relationship

Franchisor

↕

Master Franchisee

↕

Unit Franchisees
<table>
<thead>
<tr>
<th>Unit Franchise</th>
<th>Area Development</th>
<th>Master Franchise</th>
</tr>
</thead>
<tbody>
<tr>
<td>Franchisee</td>
<td>Developer</td>
<td>Master franchisee</td>
</tr>
<tr>
<td>Opens/operates unit franchises</td>
<td>Opens/operates several unit franchises itself</td>
<td>Opens unit franchises and/or grants others right to open/operate unit franchises</td>
</tr>
</tbody>
</table>
Example 1

Master Franchising
Franchisor
↓
Master franchisee
↓
Territory

Franchise Unit 1
By January 1, 2009

Franchise Unit 2
By July 1, 2009

Franchise Unit 3
By January 1, 2010
Example 2

Master Franchising
Franchisor
↓
Master franchisee
↓
Territory

Co-owned
Unit 1

Co-owned
Unit 2

Franchise
Unit 1

Franchise
Unit 2

Area
Developer

Schedule: open at least 1 every six months
Area representative / development agent franchise

• 3 parties
  – Franchisor
  – Area representative or development agent ("M")
  – Unit franchisee
Area representative / development agent franchise

- 2 agreements
  - Area representative / development agent agreement
  - Unit franchise agreement
- Franchisor contracts with master franchise.
- Franchisor contracts with franchisee, but M has no contract with franchisee.
What features do 3-party programs have in common?

1. Master franchisee is an independent contractor
2. Master franchisee uses his own resources to recruit and/or support franchisees
3. Master franchisee pays a fee for right
4. Master franchisee is compensated from fees generated by franchisees assigned to him
5. Master franchisee’s rights are subject to meeting a development schedule
Development Agent/ Area Representative

- Development Agent
- Franchisor
- Franchisee

privity
What features do 3-tier programs have in common?

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What features are (often) different in 3-tier programs?

<table>
<thead>
<tr>
<th></th>
<th>Master Franchisee</th>
<th>Area Representative/ Development Agent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract privity w/zees</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Collect fees from zees</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Startup support to zees</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Initial training of zees</td>
<td>Maybe</td>
<td>Maybe</td>
</tr>
<tr>
<td>Ongoing support to zees</td>
<td>Yes</td>
<td>Usually</td>
</tr>
<tr>
<td>Duty to enforce franchise agreements</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>May operate unit franchise (separate agreement)</td>
<td>Usually</td>
<td>Sometimes</td>
</tr>
</tbody>
</table>
• Which formats have your companies used for international expansion and why?
What do parties to a master franchise relationship contribute?

- Franchisor provides:
  - Trademark
  - Training and assistance in acting as a franchisor
  - Operating system for operating unit franchises
  - Form of unit franchise agreement
  - Access to its resources concerning franchise businesses
What do parties to a master franchise relationship contribute?

- Master franchisee provides:
  - Capital
  - Management
  - Local market knowledge
  - Support to franchisees
  - Fees to franchisor
What do parties to a master franchise relationship contribute?

• Unit franchisee provides:
  – Capital at unit level
  – Local management and human resources
  – Micro market knowledge
  – Fees to master and franchisor
Company owned expansion v. master franchising

- Master franchising
  - Allows growth and support using other people’s money
Company owned expansion v. master franchising

- Company owned model
  - Each restaurant unit has 20 employees
  - 30 restaurants equals 600 employees
• 1 field representative per 10 restaurants = 3 field representatives
• 1 manager X 10 field representatives + plus office computers, benefits
• Company owned model has 634 employees
  – plus payroll, benefits, rent and overhead
Master franchise model

Franchisor Perspective

- 30 restaurant franchises granted by master franchisee
- 0 restaurant employees
- 0 restaurant field support staff
- 1 manager
- Relatively nominal office overhead (domestically), i.e., low marginal cost
What are the benefits of international master franchising?

1. Master franchisee provides capital and human resources to grow the franchise system
2. Master franchisee bears most risk of loss
3. Master franchisee pays franchisor for the right
4. Master franchisee’s compensation is solely based upon revenues generated from franchisees in territory
5. Master franchisee is motivated by his investment and opportunity to succeed
6. Master franchisee is motivated by building equity in an asset which can be sold

7. Especially internationally, master franchisee has superior familiarity with local legal, cultural and business practices

8. Master franchisee indemnifies franchisor against claims

9. Use of master franchisees can provide an opportunity to grow business in an area in which company-owned or direct franchise operations are not fiscally justified for the franchisor
10. Master franchisee has contractual control over franchisees in territory and enforcement of agreements

11. Master franchisee undertakes much responsibility for local legal compliance, especially internationally

12. Master franchisee may have profit opportunities from supplying franchisees, as well as from franchise fees
What are the weaknesses of master franchising?

1. Less franchisor control and involvement than what may be desirable.

2. Franchisor's systems must be translated and communicated to unit franchisees through the master franchisee.

3. International master franchisees may bear too much of cost of and control over testing the system, adapting and developing it in the territory.
What are the weaknesses of master franchising?

4. Functioning as a master franchisee is difficult. After a training program, a master franchisee is supposed to be able to function as a franchisee and as a franchisor.

5. An inadequate performance in the territory may make reintroduction of the franchise very difficult in the future.
What are the weaknesses of master franchising?

6. Enforcement of agreements can be difficult and expensive.

7. Setting and meeting realistic development goals is difficult.
8. If development schedules are not met, franchisor must rely on enforcing contractual rights to meet development goals in the territory.

9. Enforcement of standards at franchisee outlets is dependent upon the efforts of master franchisee.

10. Franchisor may face claims for alleged violations of franchise laws or unit franchise agreements by master franchisee.

11. If master franchisee’s rights are terminated, franchisor must promptly find ways to support franchisees in territory.
What are problems in international master franchising?

• Hayes
  50% selling franchises and generating franchise sales leads
  33% franchisor lack of understanding of the master franchise market place
  25% inadequate support from franchises
  20% training

• Kalnins
  Overly aggressive development schedules

• Franchise International
  - Inadequate initial and ongoing training
  - Under estimation of capital requirements
  - Unrealistic development schedules
What is the best way to overcome the problem the master franchisees have selling franchises in their territories?

- Classroom training?
  When? Why?
- In territory “on the job training”
- Franchise brokers
- Franchisor – master franchisee sponsored trade shows.
- Use of franchisor’s franchise development personnel during initial sales phase.
How should franchisors overcome their lack of understanding of a master franchisee candidate’s market?
Make Sure each party – Franchisor, master franchisee and unit franchisee can make a marketable profit.
Determining profit potential must begin with an evaluation of whether unit franchisee recruiting, training and support functions allocated to franchisor and master franchisee will be paid for by their respective share of franchise fees.
In analysis of master franchise cost-benefit, consider each function needed to support franchisees.

- Which functions of a 2-party direct franchise are most effectively shifted to master franchisees?
- Which should remain with the franchisor?
- Which functions may be shared?
  - Minimize replication
• Determine how the function-cost allocation impacts the cost of doing business and break-even point for:
  – Franchisor
  – Master franchisee

• And how it may impact the success of unit franchisees.
• Does the master franchise program offers master franchises profit centers beyond splits of initial and ongoing franchise fees?
• Must master franchisees operate franchised outlets to be financially viable?
• At what point do master franchisee-operated units detract from the rationale for the master franchise program?
  – Focus on outlet operation v. development of territory
• Are the franchise formats your firms have used within the United States also used in other countries?
What are the major differences between domestic and international franchising which can impact international success?

1. Territory
   • Domestic versus international size
2. Fees
   • Initial fee
3. Royalties
   • Shared
   • Minimum
   • Tax
   • Exchange controls
4. Advertising Fees
5. Operational Support
   • Quantity
   • Expense
– 6. Training
  • Provider
  • Travel cost
  • Translation
– 7. Supply Sources
  • Transportation
  • Local standards
  • Customs and duty

What are the typical problems?
How does one determine which countries are priorities for master franchising expansion?

Prepare an international expansion feasibility study.
Identify resources and budget needed to establish an international franchising plan.
Consider all likely cost factors.

- Planning
- Opportunity cost
- International prototype franchise agreements and disclosures
- International trademark, domain name and other IP registrations
- Master franchising training and manuals
- Market research
- International consultants
- Travel time and expense
- Dedicated staff
- Extended office hours (possibly)
- International legal advice
- Financing
- New entity formation
How does one determine which countries are priorities for master franchising expansion?

Identify markets which are most likely to be most cost effective and profitable.

- Consider how each element of cost and profitability is likely to be effected in a different market, e.g.
  - Real estate
  - Equipment
  - Inventory and supplies access
  - Advertising
  - Necessary outlet demographics
  - Financing of franchise and customer purchases
- Evaluate impact of distance, language, culture and economy of each market on likely success.
- Evaluate competition.
- Consider ease of doing business and corruption reputation of the market.
How does one determine which countries are priorities for master franchising expansion?

Research tax and legal issues in high priority markets.

- Can IP be easily protected?
- Are tax treaties or other strategies available to minimize tax burdens?
- How will royalty withholding laws impact needed cash flow?
- Does the government restrict payments or currency of payments abroad?
- Is the judicial system fair? Efficient?
- What restrictions exist on conducting the business to be franchised?
- What limitations or duties are imposed on the importation of equipment, supplies and inventory needed to conduct business?
How does one determine which countries are priorities for master franchising expansion?

- Do religious laws or other laws or customs restrict the times or methods of doing business or the sale of products or services which are integral to the franchised business?
- How do franchise laws restrict the offer and sale of franchises? How do they impact the cost and time required to lawfully franchise?
- What impact do franchise relationship laws or commercial agency laws have on ending a franchise relationship?
- Do labor laws changed the cost/profit structure of business operation?
Using & Not Using Master Franchising

China
India
Jamaica
South Africa
Brazil
• Why is it important to negotiate two contracts before becoming committed to a master franchise?
Thank you.

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