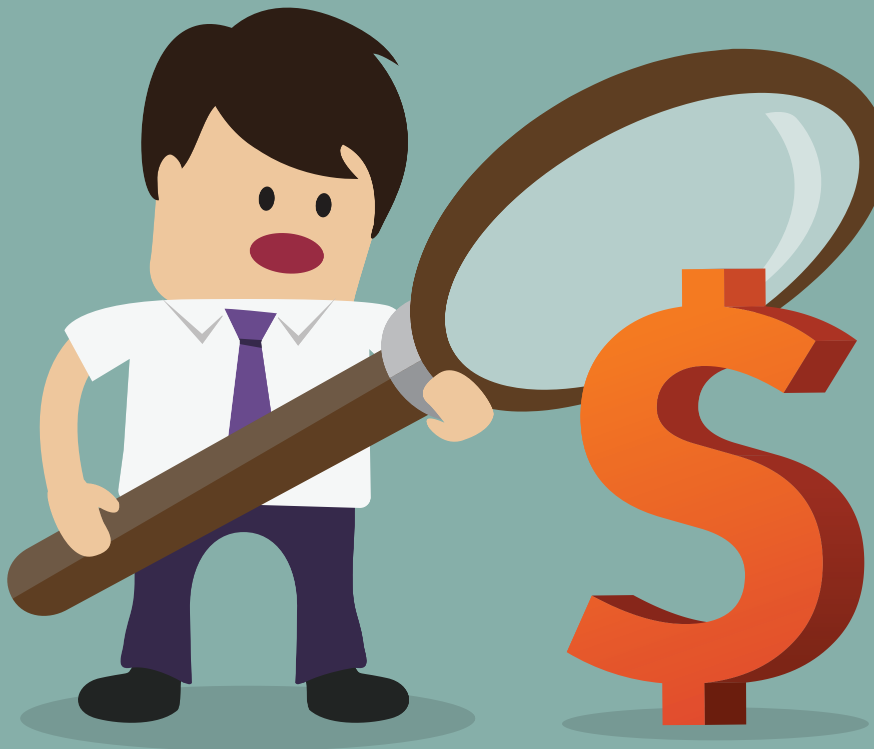

# FRANCHISE FEES FUNDAMENTALS

## The basics of what you're paying – and why!

Franchise fees are typically paid for the use of the franchisor's trademark, brand, and operating system. There is usually a one-time initial franchise fee as well as an ongoing fee, called a royalty. Additionally, most franchise companies charge a fee for an advertising fund where the advertising dollars of the franchisees are pooled together to allow for franchisees to share the costs of advertising.

### Why do some franchise systems have franchise fees while others do not?

The initial franchise fee will vary, and depends on the amount of training and support that is provided to get the newly franchised location up and running. In addition to the initial training and support, the initial franchise fee can cover the cost of franchisee recruiting, territory analysis, site identification, the grand opening launch, and some recovery of the franchise development costs. Typically the more established and recognized the franchise's brand is, the higher the initial fee.

### Franchise Royalties

Royalties are the franchisor's portion or share of the revenues for allowing you to use their trademarks and proprietary system. Ongoing royalty fees will vary: It is common to find royalties between five and six per cent for retail franchises and eight to 10 per cent for service franchises, depending upon the level of ongoing support and services that are provided by the franchisors. For example, some franchisors may provide a centralized call center with order-taking. This requires a higher cost, which is addressed with a higher royalty.

> For a franchise system to be successful, royalties need to be both affordable for the franchisee and large enough for the franchisor to fund the necessary support.

When no royalty is charged, the cost it is usually built into product sales or sale of services. Typically the more involved the franchisor is with ongoing business operations, the higher the fee. A royalty ensures that the franchisor has a vested interest in your success.

The franchisor uses royalties to develop an infrastructure that provides ongoing support to franchisees, including:

- Consulting and sharing best practices
- Arranging suppliers to capitalize on purchasing power
- Research and development
- Operational reviews and ensuring brand consistency
- Accounting systems
- Computerization
- Field support
- Initial training programs
- Ongoing training programs

For a franchise system to be successful, royalties need to be both affordable for the franchisee and large enough for the franchisor to fund the necessary support. Typically, royalties are paid monthly, calculated on the franchisee's gross sales for the month and usually do not include legitimate refunds or taxes.

There are numerous variations regarding royalty fees. Some franchisors charge escalating or declining percentages based on different levels of sales. Some franchisors do not charge a percentage of sales but instead charge a royalty based on a flat fee each month.

A flat fee royalty is often used when it is difficult for the franchisor to monitor the franchisee's monthly sales. This system may seem attractive to the franchisee since they will know exactly what they will be paying each month, but there is no incentive for the franchisor to work with their franchisees to increase their sales. The franchisor receives a flat fee each month regardless of the level of support they provide.

Revenues to the franchisor through product fees are typically used when the franchisee is distributing a product manufactured or distributed by the franchisor. Examples of a product-based franchise are gas stations, automobile dealerships, or soft-drink bottlers. Product franchising derives income from selling products wholesale to the franchisees, with a profit margin for the franchisor built into the wholesale pricing. The franchisee is required by the licence agreement to purchase products from the franchisor.

Royalties are usually non-negotiable and often pre-set by the franchisor. If one franchisee is paying four percent and another is paying eight percent, there could be potential conflicts within the franchise system. For the most part, royalty fees are constant and do not change. Exceptions to this could occur if a franchisee was awarded a franchise of a fairly new and emerging franchise system. When joining a franchise system at the early stages of growth, franchisees may receive the benefits of lower royalties while the emerging franchise system is starting out. As the franchise grows so should the operating systems and support. When renewing their franchise agreement, franchisees may then be faced with an increase to their royalty fees.

Low royalty fees are not necessarily an advantage, as low fees can result in the franchisor's inability to provide franchisees with the necessary level of support and ensure the success of the system.

Most franchise agreements have a clause stating that failure to pay royalties is a breach of the franchise agreement and may lead to the termination of the agreement. The franchisee may then also be liable for other damages.

The benefits of paying royalty fees often far outweigh the costs. A royalty gives the franchisee the right to operate a business under a proven brand and business model. However, prospective franchisees must always do their due diligence when looking at any franchise opportunity. Speaking with current and past franchisees of the franchise system will help to ensure that the value for the royalties is there.

## Advertising Fees

In most franchise systems the franchisee is required to contribute a certain amount of money for regional and/or national advertising. Advertising is expensive and when all the franchisees put their money together, they are able to execute advertising initiatives that may not have been affordable otherwise.

Advertising fees are calculated on a percentage of a franchisee's gross sales, usually ranging from one to four per cent, collected monthly. Every franchise system works differently: some franchisors charge a flat fee while other franchisors have no advertising fee at all. Some franchisors will put a cap on minimum and maximum advertising fees, so that the fund is a collaboration of all franchisees in the system and not supported by just the highest earners.

The management of the advertising funds is often separate from royalties and the general revenues of the franchisor. It is not considered income of the franchisor but rather funds collected "in trust" for a specific purpose. Franchisors may charge a management fee for administering the advertising fund. Franchisees can typically request to see the financial statements regarding how the funds were spent.

To further support the management of the advertising fund, some franchisors will set up an advisory council or marketing committee wherein franchisees can provide input into the use of the funds. Input from franchisees leads to better decisions on how to utilize ad fund dollars as well as lead to greater buy-in to those decisions. Advertising/marketing programs are often evaluated for effectiveness to ensure the return on investment of marketing dollars.

For the most part advertising fees are constant and do not change. An exception to this could be a fairly new and emerging franchise system. Emerging franchise systems may require lower advertising fees, but as the franchise grows so does brand awareness, and the franchisor may find that the advertising fees being collected don't support the advertising and marketing initiatives required. They may then ask franchisees to increase the percentage they contribute to the advertising fund.

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In addition to the national/regional marketing funds, franchisees should be aware that they will typically be required to spend money on local marketing initiatives. While the national/regional advertising drives brand awareness, local marketing initiatives drive customers to specific locations. Most franchise agreements stipulate that franchisees are financially responsible for carrying out local market advertising each month, often predetermined as a percentage of monthly sales ranging from one to three per cent. Franchisees may also be required to participate in local co-operative advertising with other franchisees in their area.

It is recommended that franchisees review advertising fee requirements in their franchise agreements. Here are a few questions to ask for a better understanding of the national/regional advertising fund:

- What type of advertising has been done in the past?
- What advertising/marketing initiatives are planned for the near future?
- How is the money held?
- Is the fund segregated from the franchisor's regular accounts?
- Will the franchisor provide accounting or financial statements, pertaining to the funds expenditures, to the franchisees?
- How much of the fund is used to pay administrative expenses?
- Is there an advisory council set up and how many franchisees sit on this advisory council?

## Renewal Fees and Redesign Costs

When it comes time to renew your franchise agreement, there will typically be a renewal fee and redesign or remodeling costs. This may include changes to the branding elements, equipment and technology and/or remodeling the physical premises of your location. Changes in the system are required in order for the brand to evolve, develop and remain competitive. Franchisors will often involve the franchisees and ask for input through a franchisee advisory council or committee.

The costs of renewal will be defined in your franchise agreement and will reflect the franchisor's attitude and market conditions. Costs can vary anywhere from nothing, to a percentage of the current franchise fee, to the amount of the initial franchise fee.

It makes sense for the franchisor to encourage renewals and keep costs low. The alternative is to spend a lot of time, effort and money on finding new franchisees, finding new locations and training the new franchisee.

If your agreement has a longer term, it may require that changes be made during the term as well, not just at the time of renewal. Franchisors will provide a reasonable amount of time to make the changes, but will often not renew your agreement unless the changes are made.

Some franchisors will offer financial assistance to facilitate these changes. Some franchise agreements will set a cap as to the cost of these changes, but it is very difficult for franchisors to forecast what the changes and the applicable costs will be five to 10 years into the future. As a result, the franchise agreement will speak of required upgrades in general terms.

Another cost at time of renewal may be training to upgrade the franchisee and staff. If there is new equipment, your employees will need to be trained on the new equipment and processes and you will have to cover the costs of that training.

Before you renew your agreement, have a full understanding of what the total costs are going to be and ensure that you have access to the funds required. You will want to ensure that you have sufficient time in the renewal term to get a return on your new investment. Successful franchisors will be sensitive to this fact, while at the same time balancing this against the need to keep the brand current and contemporary.

### Deposits

Often franchisors will collect a deposit prior to entering into a full franchise agreement. Franchisors often deal with hundreds of enquiries every month and simply cannot begin to find locations or assist with bank financing for everyone, so a deposit helps franchisors differentiate the serious candidates from casual enquiries.

Deposits are typically a percentage of the initial franchise fee or the full initial franchise fee amount. When entering into a franchise agreement, the deposit is credited towards the amounts owing. Should the potential franchisee choose not to move forward with the agreement, the deposit may or may not be refunded.

From a potential franchisee perspective, deposits will often permit one to put a territory on hold so that the potential franchisee can do their due diligence, arrange financing, have documents reviewed by a lawyer, or find an approved location.