Royalty Dollars and Sense

A short primer on royalties and tips for developing successful programs.

Background and Development: Of the myriad changes in the franchise marketplace over the past several decades, one of the most notable has been adaptation of the franchising model across a broader cross section of concepts, industries and market segments. Today, more offerings are available to a more diverse group of prospective franchisees than ever before in the history of franchising. The Internet has opened up a wealth of information related to franchising and the franchisor–franchisee relationship has experienced maturation. Attracting increasingly savvy investors to a particular brand requires a sophisticated offering capable of appealing to and accommodating franchisees at all stages of development, levels of production, and sizes ranging from a single unit to franchisee corporations owning up to hundreds of units. In this ultra competitive landscape, franchisors cannot afford to take any part of their franchise offering for granted, including royalties.

Royalties are fuel that drives franchise systems, and all franchisors assess franchisee royalties in some form or fashion. Although a few franchisors claim to be royalty free, such hair splitting calls to mind an ex-president who claimed not to have had relations with a certain intern. Franchisors must derive income from franchisees in order to thrive, whether it is referred to as royalties, or markups, as some prefer. Whereas all franchisors are required to disclose fee types and formulas, a minority of franchisors actually disclose the consideration for royalties that franchisees are required to contribute. Thus, many franchisors end up missing a golden opportunity to begin selling royalties from the very first meeting with prospective franchisees. The few franchisors that do highlight their innovative royalty programs positively differentiate their offerings and promote franchisee understanding and acceptance that promise to stand the test of time.

Rule #1	All franchise systems are sales organizations.
Rule #2	Every component of a franchise network must sell all of the time.
Rule #3	Royalties are no exception to Rule #2.

To say franchisors tend to take a conservative approach to royalty development is an understatement. An IFA Education Foundation-FRANdata study of the franchise marketplace, based on year 2006 information, revealed that most franchisors charge franchisees a royalty based on a percentage of gross sales. Easy accessibility to competitor franchise disclosure documents may play a role in franchisors mimicking one another's royalties, as may the desire to "play it safe". However, with millions to billions of future dollars at stake, and contemporary royalties more befitting of the cliché expressions "*one size fits all*" and "*if it ain't broke don't fix it*", a methodical approach to royalty development is definitely in order.

Successful royalty programs should begin with a team composed of experienced franchisor leadership, a franchise consultant, franchise specific attorney, and a CPA or tax advisor. Best practices suggest strategizing and documenting a comprehensive list of royalty related issues, opportunities, challenges and objectives. The goal being to develop royalty "rules of thumb" that closely align with the franchisor's business plans and financial proformas, and help strike balance among business, financial and stakeholder considerations.

Of course, no royalty program would be complete without a formal definition for the franchise agreement.

Sample Royalty Definition: Franchisee payments based on a formula related to franchise unit gross sales, gross margin, production, facility size or other factors, remitted to or collected by franchisor on a periodic basis throughout the franchise agreement term as consideration for the ongoing value of franchisor; i) proprietary brands, systems, materials, training, support, products and services, ii) brand promotion and perpetuation of the network, iii) lost or deferred opportunity to place additional units or replace underperforming units within existing franchisee markets, iv) corporate overhead, and v) company and shareholder profit.

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Challenges, Opportunities and Solutions: Franchise system fees and royalties are fundamentally designed to support the franchisor, which in turn supports and perpetuates the franchise network. Initial franchise fees temporarily sustain franchisors until royalties increase and support costs decrease for new franchisee units coming on line. As franchisees gain confidence and their cumulative experience increases over time, they typically require less and less franchisor intervention and support. The quicker franchisors can help franchisees establish self sustaining businesses that are internally funded by unit generated cash flows, the faster they derive a profit from royalties. Consequently, new franchisees tend to perceive a high level of value per royalty dollar as a direct result of franchisors' strong financial incentive. The challenge is to enable both franchisors and franchisees to maintain consistently high levels of financial motivation throughout the term of the franchise agreement, without leaving money on the table, appearing greedy, or going out of business. Franchisors utilize a variety of techniques and controls to help optimize the incentive vs. profit equation; however progressive royalty programs appear to be an untapped solution just waiting to be exploited for this very purpose.

Franchisors all struggle from time to time to maintain reasonably consistent franchisee perceptions of value. This issue can become increasingly troublesome as franchisees and entire franchise networks mature and attain widely disproportionate levels of financial performance. In fact, it is not unheard of for franchisees' royalties to exceed the total amount they compensate themselves from their businesses. At one extreme franchisors that provide excessive support may inadvertently yield overly dependent franchisees, which makes the pattern all the harder to break, or worse, may not generate sufficient profit to perpetuate the network or even remain in business. At the other end of the spectrum, franchisors that deliver too little support for their royalties may be negatively perceived as profiteers, with some franchisees feeling they no longer need the franchisor and thinking they might be better off as independents.

The business world commonly employs financial incentives in the form of discounts and rebates, especially as monetary or production volumes rise, and for prompt payment of monies owed. The purpose of such incentives is to keep clients coming back, stimulate increased consumption and timely cash flows. This sound practice transcends retail as well as business to business environments. Conversely, financial incentives for accommodating high volume franchise units, or encouraging franchisee compliance, are conspicuous by their absence. Generally, the greater a franchisee's production, the correspondingly greater the royalty, without regard to support and services required by franchisees or offered by franchisors, and without consideration of franchisee compliance. Franchising's non-conformity to general business practice in this regard may be due to franchisors' traditional reliance on termination provisions to enforce compliance in event of franchisee default.

Fast forward to the 21st century. People in general, and franchisees in particular, tend to form preconceived notions of fairness and value, which once breached, are difficult to reestablish. Thus, any perceived gross inequity relative to royalties, if exacerbated by one or more issues franchisees did not appreciate and cannot find it in themselves to forgive the franchisor, may result in franchisee resistance ranging from verbal or written challenges, to non compliance, to the ultimate take away of exiting the franchise network.

Royalties can be costly for franchisors to administer in other ways as well, such as the infrastructure and staff necessary to operate accounts receivable and collections departments. At one time or another, all franchisors will be confronted with the decision to indirectly offer financing to, or initiate termination proceedings against, franchisees that have underreported or fallen delinquent in their royalties. Disputes related to royalties can drain both franchisor and franchisee finances as well as the goodwill built up in the relationships over many years. Franchise leaders that pay attention to cause and effect, and behind the scenes costs associated with their current or proposed royalty programs, will be better prepared than competitors that maintain the status quo.

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What matters most are the opinions of franchise prospects, investors and lenders who have a vested interest in conducting business with successful franchisors that demonstrate staying power. Sophisticated stakeholders look for franchisors to maximize promotion of the brand, drive consistent expansion of the franchise network, and retain successful, well motivated franchisees. To meet these expectations franchisors are well served to proportion income among initial franchise fees, full royalties for units from start up into the growth cycle, and adjusted, reduced or rebated royalties for mature high volume units. Franchisee and stakeholder confidence is inspired by franchisors that fairly and consistently apply financial incentives and sanctions to enhance value and reward compliance; resorting to legal enforcement for only the most material or chronic breaches.

Innovative yet practical royalty programs should be a key component of every franchise offering. To be effective, royalties need not be overly complex or convoluted. Often, the most elegant solutions are derived through the simple process of eliminating royalty formulas that do not achieve desired results and modifying those that come close. While there are no "perfect" royalties for every circumstance, royalty formulas can and should be individually optimized for franchise networks and their stakeholders. A side benefit to well executed royalty development is the positive influence the process and the resulting program can exert on members of the franchise network to apply a similar level of care and creativity as they help build the network.

If your royalties are not making dollars and sense for your franchise network, now is the time to perform an evaluation and begin development of a winning program that will help achieve the success you desire.

Disclaimer: This article is solely intended to stimulate the thought process of franchisor leadership regarding royalty evaluation and development. Franchisors are strongly advised to consult with franchise consultants and licensed professional attorneys, CPA's and tax advisors of their own choosing prior to implementation of any royalty program into their franchise offering.

Sample Royalty Formulas:

1. Fixed percentage of franchisee gross sales revenues, e.g. 5% per week, month, etc.
2. Fixed percentage of franchisee gross sales revenues per various lines of business, products, clients, etc., e.g. 4% on one line, 6% on another, and 8% on a third line, etc.
3. Floating percentage of franchisee gross sales revenues adjustable based on internal network performance, e.g. if a franchise unit performs at or greater than the franchise network average mean production for all units their effect royalty rate will be 2% lower than the fixed or flat rate, and if a franchise unit performs below the franchise network average production for all units their effect royalty rate will be 2% higher than the fixed or flat royalty rate, or 101 other variations on this theme.
4. Graduated percentage of franchisee gross sales revenues; e.g. 7% of gross rev up to $250,000, plus 5% of gross rev from $250,001 to $500,000, plus 3% of gross revenue from $500,001 to $750,000, plus 1% from $750,001 and up.
5. Fixed percentage of franchisee gross margin, e.g. 60/40, 70/30, etc. (60% Franchisee / 40% Franchisor royalty).
6. Fixed percentage of franchisee use/purchase of franchisor required products/services, e.g. 2% - 10% added to cost.
7. Fixed dollar amount per square foot of Franchise unit rentable floor space, e.g. $1.00 per sq. ft. per month.
8. Fixed dollar amount per unit per period, e.g. $500 per month for year 1, $750 per month in year 2, etc.
9. Fixed dollar amount per unit transaction, e.g. $25.00 per new student enrolled.
10. Alternate minimum dollar amounts per defined period, e.g. $100 min per week, $500 min per month, etc.
11. Dollar amounts or percentages periodically adjustable according to pre-defined amounts or percentages and/or pre-established multiples of institutionalized governmental indices such as the Consumer Price Index ("CPI") as published by the Bureau of Labor Statistics in the US Department of Labor, or other reliable method of adjustability over time.
12. Combination of one or more royalty and/or rebate formulas.

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Suggested Talking Points for Developing and Evaluating Franchise Royalty Concepts:

1. Accommodates franchisor anticipated costs related to maintaining its proprietary brands, systems, materials, training, support, products and services, promoting the brand and perpetuation of the network, lost or deferred opportunity to place additional units or replace underperforming units in existing franchisee markets, corporate overhead, and company and shareholder profit in accordance with franchisor's business plan and multi-year financial proforma?
2. Affect on the future value of the franchisor for attracting □Lenders □Investors □Acquirers?
3. Affect on the future value of individual franchisee units for attracting □Lenders □Investors □Acquirers?
4. Perception of franchisor □Lenders □Investors □Stakeholders?
5. Perception of franchisee □Lenders □Investors □Stakeholders?
6. Perception of □New franchisees □Existing franchisees?
7. Affect on differentiation of franchise offering from competitor offerings?
8. Affect on ongoing cooperation between franchisees and franchisor?
9. Affect on franchisee compliance with material terms and conditions of franchise agreement?
10. Affect on franchisees at various levels of □Financial performance □Production volume □Unit counts □Unit location?
11. Affect on □Low performing □Top performing franchisees to achieve greater financial success?
12. Affect on top performing franchisees to open and/or acquire expansion units?
13. Affect on subsidy of underperforming franchise units owned by multi-unit franchisees?
14. Affect on honest and timely franchisee reporting of unit production or other basis of royalty computation?
15. Affords reasonable controls and protections against franchisee circumvention and under reporting.
16. Affords ease of forensic auditing of franchisees by □Franchisor □Independent 3rd party?
17. Affect on franchisor to continually work with franchisees to drive □Top line revenues □Bottom line profits?
18. Affect on franchisor's □Promotion of the brand □Expansion of the franchise network?
19. Affect on franchisees cooperatively working together to more thoroughly penetrate and dominate target markets?
20. Accommodates national accounts and other forms of shared business between and among franchisees and franchisor?
21. Affords opportunity of a windfall for the top performing □Unit(s) □Franchisee(s) within a specified time period?
22. Affect on franchisees ability to profitably compete with competitors?
23. Accommodates franchisee □Startups □Expansions □Satellites □Acquisitions □Conversions □Re-sales?
24. Accommodates □Individual units only □Consolidation of all units under common majority ownership?
25. Accommodates □Demographic □Geographic □Seasonal □Economic variations within franchise unit target markets?
26. Accommodates □New □Existing □Single unit □Multi-unit □Area Developers □Master Franchisees?
27. Suitable for □Base franchise offering □Single year special program □Multi-year special program?
28. Accommodates adjustability over time?
29. Accommodates □Manual □Automatic adjustability?
30. Adjustability established by □Franchisor □Network performance □Governmental indices □Other?
31. Adjustability accommodates □Advancing economies □Declining economies?
32. Royalty formula; □Fixed % of franchisee gross sales □Graduated % of franchisee gross sales □Fixed percentage of franchisee gross sales per various lines of business, products, clients, etc., □Fixed %, single franchisee gross margin □Fixed % Multiple Franchisee gross margin □Flat fee □Floating percentage of franchisee gross sales adjustable based on network performance, □Fixed dollar amount per square foot of franchise unit rentable floor space □Fixed dollar amount per unit per period □Fixed dollar amount per unit transaction □Alternate minimum dollar amount per defined period □Combination of one or more royalty formulas □Combination of one or more royalty rebate formulas □Other?
33. Royalty program □Documentation □Definition □Franchisor consideration □Formula(s) □Examples?
34. Royalty formula and written examples are simple to communicate and easily understood by franchisees and others.
35. Royalty dollar amount □Min per period $_____ □Max per period $______ □Unlimited □Lifetime maximum □Other?
36. Royalty period □By transaction □Daily □Weekly □Bi-monthly □Monthly □Other______
37. Royalty submission □Check □Wire transfer □Bank draft □Deduction from collected receivables □Other_____?
38. Accommodates franchisee negotiation of royalty formula(s) with franchisor at franchise agreement signing?
39. Royalty rebate vs. adjustable or reduced royalties?
40. Royalty rebate threshold established by □Franchisor □Network performance □Government indices □Other?
41. Royalty rebate basis □Individual units only □Consolidates all units under common majority ownership?
42. Royalty rebate period □Immediate □1 week □2 weeks □month □quarter □6 months □year □Other?
43. Franchisor back office accounting and financial software accommodates multiple royalty formulas for the entire franchise system as well as per individual franchisee, franchisee unit, line of business, client, transaction, etc.?
44. Franchisee front office and back office accounting/financial software accommodates franchisor royalty reporting requirements per franchisee unit, line of business, client, transaction, etc.?

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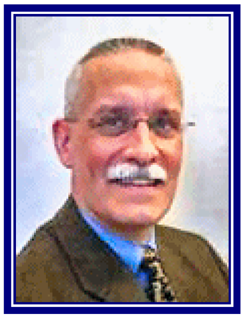
About the Author:

Bob Snelling is president and founder of Honor Capital Group, LLC a small business consultancy and finance intermediary, and the author of Tip Top Docs brand of professional business documents.



Bob's diverse business experience spans multiple industries dealing with products, services and people. Serving as an employee in various positions from warehouse to boardroom Bob has directly reported to no less than five extraordinarily different company presidents. As a business owner making decisions, setting budgets, and meeting payrolls for up to thousands of employees, Bob has known first hand what it is to maintain legal, operational and P & L responsibility. Performing in the roles of senior level executive, CEO, board director and major shareholder of Snelling and Snelling, Inc., a national, and for many years international company with hundreds of franchised and corporate units, Bob has by necessity perfected leadership skills that are tolerant and respectful of widely divergent perspectives.

A unique background with progressive levels of operational, managerial and financial responsibility has proved invaluable preparation for Bob's current role as business advisor and finance intermediary. Guided by ethical behavior, attention to detail, and a regimen of planning, collaboration and teamwork, Bob's innovative yet practical solutions consistently deliver return on investment and stand the test of time. Decades invested in the identification and implementation of sustainable best practices uniquely qualifies Bob to author relevant topics that today's franchised and independent business leaders can immediately benefit from and put into action.

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