Document 6



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# AUSTRALIA POST

## REVIEW OF POSTSHOP FRANCHISE CONCEPT & PILOT SITES

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# 1. Compilation Report

## 1.1 The Purpose of the POSTshop Review

An opportunity was identified by Australia Post to introduce franchising within its retail outlets as an alternative outsourcing arrangement. A franchise package was developed by Australia Post's Franchise Project Team and tested in four pilot locations.

Ernst & Young has been engaged by Australia Post to analyse the franchised POSTshop concept and independently review the pilot results by undertaking both a quantitative and qualitative analysis.

Our review compares Post's desktop modelling projections with actual performance at the pilot. We will also compare the franchise package and the pilot results to industry best practice.

## 1.2 Scope

On the basis of information provided by Australia Post we have compiled a report on the feasibility of the franchise concept.

Our procedures use accounting expertise to collect classify and summarise the financial information, which Australia Post has provided. Our procedures do not include verification and validation procedures. No audit or review has been performed and accordingly no assurance is expressed. Forecasts, by their nature, are based on estimates and assumptions and cannot be relied upon as certain.

To the extent permitted by law we do not accept liability for any loss or damage which any person other than Australia Post may suffer from any negligence on our part. No person should rely on the forecasts without having an audit review conducted.

Ernst & Young

ERNST & YOUNG

## 2. Executive Summary

### 2.1 POSTshop Concept

The POSTshop concept is a sound model for franchising with few adjustments.

- The fee structure would appear to be reasonable and is in line with best practice results in the franchising sector.
- Our main recommendation in regard to fees is that an earnings before interest and tax multiple is used to determine the value of the franchise sites.
- We believe that it would be unwise for Australia Post to share in any subsequent goodwill on the resale of the franchise
- We recommend that a renewal fee is charged at the expiry of the franchise agreement which would be negotiated taking into account increases in Australia Posts costs.
- An independent review of the correct transfer prices should be undertaken to determine an equitable price structure.
- The franchise agreement should contain specific clauses in regard to territory.
- The issue of competition by Australia Post will also need to be addressed.

### 2.2 Pilot Results Analysis

- The pilots have been established in line with the concept proposed.
- The functions required to support the franchise concept are being developed through the pilots.
- We understand that greater measures are now being undertaken to collect additional data for analysis of areas such as financial performance and customer service standards which were unavailable at the time of this report.
- We recommend continuation of the pilot sites to allow a more complete financial analysis.
- We believe that extension of the pilots is necessary to fully test all aspects of the franchise concept.
- The format must continue to be run at the four sites while the results to March 2000 are being evaluated and a recommendation is made as to the future of franchising.
- If the results to March substantiate this model Australia Post may wish to test this theory further by way of a limited roll out.

## 2.3 Pilot Sites Results Compared

- From the information currently available the pilot results support the desktop model projections.
- We propose that the franchise fee may be increased from [redacted].

# 3. Methodology

## 3.1 Major Steps

After reading all available documentation we were able to identify the critical areas of success for Australia Post. The major two areas identified were financial performance and customer satisfaction.

By benchmarking the franchise format against our knowledge base and best practice we were able to determine if the format designed was capable of producing the required returns. Further by conducting interviews we were able to determine if the major assumptions were achieved at the pilot sites. We also performed quantitative analysis of key performance indicators to assess the financial performance of the franchises. A review of the fee structure was undertaken to test the potential for acceptance in the market.

A series of interviews were conducted with various people within retail operations both in Victoria and New South Wales to assess the feasibility of introducing the franchise concept to Australia Post.

All data collected was compiled and subsequently analysed to form the basis of our report and the data collected will be referred to by various appendices throughout this report.

## 3.2 Consultation

After discussion with the Franchise Project Team consisting of Peter Hynes and Gary Ward we were able to identify the relevant stakeholders in the franchise project as listed below:-

| RETAIL OPERATIONS | | |
|---|---|---|
| Titles | Victoria | New South Wales |
| Franchisees of Pilot Sites | Michael Rendina<br>- Bacchus Marsh | Bruce Conroy<br>- Sydney West Region |
| | | John Rooke<br>- Southern Sydney Region |
| | | Frances Sodaro<br>- Sydney Metro |
| Area Manager | Paul Lecher | Chris Powell |

| HEADQUARTERS | | | |
|---|---|---|---|
| Area | Titles | | |
| Retail | Head of Retail Operations | Michael Talbot | |
| Retail Marketing | Manager | Sebastian Parkes | |
| Financial Services | National Manager | Terry Stephens | |
| Retail Operational Best Practice | Manager | Elizabeth Philip | |
| Retail Technology | Manager | Shane Morris | |
| Financial Controller Retail Group | | Alan Vallance - | |
| Retail Operations Policy | Manager | Graeme O'Brien | |
| | | | |
| STATES | | | |
| | | Victoria | New South Wales |
| | | | |
| Retail | State Manager | John Heyward (Acting) | Mark Warren |
| | Branch Manager | Michael Keen | Dennis Harelle |
| | Consultant | Neil Anderson | |
| Support Services Group | Manager | | David Mitchell |
| Retail Revenue Unit | Manager | | Michael Tyne |
| Retail Products | Manager | | David Swaney |
| Retail Logistics & Technology | Manager | | Maria Soto |
| Finance & Accounting Department | | | Victor Lin |
| Finance & Accounting Department | | | Greg Grose |
| Retail Support Co-ordinator | | | Elizabeth Karenfilovski |
| Retail Maintenance Centre | | | Bogdan Kwiatkowski |
| Retail Maintenance Centre | | | Wayne Thompson |
| Property Development | | | Phil Grant |

We have interviewed the stakeholders above as part of our review of the franchise concept and pilot results.

# 4. Foundations of Franchise Concept

## 4.1 Assessment of Current Model

The current franchise model has been developed by the franchise team in consultation with Horwath (NSW) Pty Ltd, HR Dimensions and Arthur Andersen. The major features of the franchise agreement are as follows

### Compliance Required

All of the following criteria are determined by Australia Post

Location:

- Australia Post chooses location.
- Australia Post retains head lease.

Image:

- Signage and branding.
- Corporate Wardrobe.

Product Range:

- How product is ordered.
- How Payment is made (terms & conditions).
- Where product is ordered from.
- Minimum Stock requirements.

Training:

- Uniform approach to training

Advertising:

- Advertising organised centrally

Store Layout:

- Australia Post performs fitout.
- Fixtures & Fittings used are supplied by Australia Post.

It is envisaged that franchised POSTshops will be:

- Single site operations.
- Mainly capital city based.
- Offer a full range of Australia Post products and services.
- Offer a wide range of ancillary products.
- Retail revenue between [redacted] per annum.

### Other Components of the Standardised Format

Each outlet must also comply with the following:

- Prime Location
- Outlet size
- Number of counter positions
- Position of merchandise
- Consistent merchandise
- Consistent service offer
- Easily identified Post brand association
- Consistent trading hours
- Operations manual
- Defined Selection Criteria

## 4.2 Decision Criteria

The decision criteria used to evaluate the distribution options were;

Financial Performance:

- The financial return to Post is to the order of that which would be achieved if the outlet was converted to an LPO.
- The franchise generates sufficient returns to a Franchisee.

Customer Service Standards:

- The customer perception of service is at least equal to a corporate outlet.

Management Support:

- Whether Australia Post is able to support a franchise system.

Support requirements and Cost:

- The operation support costs are significantly lower than at a corporate outlet.

Training Systems:

- The quality of Training support is at least equal to that delivered to POSTshops and the cost of delivery is significantly less.

Simplified Payment System:

- The payment system for franchised POSTshops is less complex, easier to maintain; more encouraging of appropriate behaviour; and more directed towards achievement of performance targets than the LPO system.

Selection Process / Compliance:

- The selection process results in the selection of Franchisees who comply with the Franchise system.

## 4.3 Overview of the Franchised POSTshop

### 4.3.1 Franchise Fees

Upfront Fees:

- Goodwill:

  The franchisee will pay Australia Post an up-front goodwill payment for each franchise site, the proposed average site goodwill payment is [redacted].

- Franchise Fee:

  The franchisee will also pay an initial once off franchise application fee which will cover Australia Post administration and legal costs in establishing the franchise system. This fee has been proposed to be [redacted] per franchisee.

- Stock:

  This is to purchase the original allotment of stock required to initially stock the POSTshop to Australia Post requirements at an average cost of $50,000

- Training:

  Post proposes charging an upfront fee of $10,000 plus $1,000 for each employee.

Ongoing Fees:

- Technology Levy:

  This pays for the rental and maintenance of EPOS software and hardware and has been set at [redacted] per computer.

- Rent:

  The rental charges will vary at each franchise location but is expected to be in the vacinity of [redacted] per sq.m.

- Advertising Levy:

  It was suggested that a 2% levy should be charged. Provision has been made in the agreement to charge an advertising levy but no decision has been taken on this.

- Ongoing Franchise Fee:

  Australia Post will receive a monthly fee equivalent to 30% of Retail Revenue. This levy has been calculated to achieve Post's required rate of return and sufficient profit to the franchisee.

### 4.3.2 Franchisee Profile

- The franchisee would be the operational manager of the business rather than a private investor.
- The franchisees will be selected according to a strict selection criteria.

### 4.3.3 Franchise Territory

- Each franchise will be for a specific site rather than a defined geographical territory.
- Australia Post determines location and retains head lease on premises and is responsible for the fitout.

### 4.3.4 Franchise Agreement

- Franchisee behaviour will be regulated by mechanisms established by Australia Post to ensure consistency with Australia Post objectives.
- Franchise agreements will be for a term of 5 years with an option to renew for another 5 years.
- Franchisees have a right to assign the franchise but Australia Post has the first right of refusal.
- Termination occurs if there is a 'material' breach.
- Disputes are managed by a specific formal dispute resolution procedure.
- Only approved products can be sold.

- Standards in regard to customer service and operational issues must be followed.
- Financial reporting is to be done in Australia Post approved format.

## 4.4 Best Practice Comparison

### 4.4.1 Franchise Fees

Upfront Fees:

- Goodwill:

  In valuing the franchise the following methods of valuation should be considered:

  1. Capitalisation of Future Maintainable Earnings before interest and tax (EBIT)

     This method is normally applied in valuing a business as a whole or an equity interest in an entity, where that entity exhibits a profit history and expects to trade profitability in the future.

  2. Net Tangible Asset Backing

     The net tangible asset backing should always be considered as it supports the underlying strength of the earnings of the business.

     The net tangible assets represents the surplus of tangible assets over the liabilities of the business on a going concern basis. The difference between the net tangible assets of a business and the value of the business, based on its capitalised future maintainable earnings is considered to represent the goodwill of the business.

     Whilst we have considered this methodology it is our opinion that it is inappropriate in the circumstances.

3. Net Tangible Assets on a Notional Liquidation Basis

   This method of valuation is considered to represent the minimum value of a business and should be considered where businesses are making losses, or where the entities have a limited life and a going concern basis is inappropriate. We do not consider this to be appropriate for the POSTshop valuation.

4. Rule of Thumb

   This method is normally applied in circumstances where an estimate of the value of the business is required or as a check of valuations determined by other methods. Accordingly, it is inappropriate to use this method as the sole basis to value the POSTshops.

After consideration of the respective methodologies it is our opinion that the capitalisation of future maintainable earnings before interest and tax is the most appropriate methodology. It is also the methodology most commonly used in practice.

Under this methodology the future maintainable earnings of the POSTshop are calculated and then multiplied by an EBIT multiple to determine the value of the POSTshop as a whole.

1. Future maintainable earnings before interest and tax

   The future maintainable earnings before interest and tax should be calculated based on the average of the projected profits of the POSTshop. Future maintainable earnings includes provision for a reasonable arms length managers salary.

2. EBIT Multiple

   The EBIT multiple which is applied when valuing a business is a matter of the valuer's judgement. It is accepted commercial practice that when determining an EBIT multiple that factors such as the following require consideration:-

2.1 General Factors

- the future prospects of the business;
- present profitability of the business;
- past profitability of the business.
- rates of return of other investments eg current interest rates;
- overall risk.

2.2 Specific Factors

- the existing competition;
- the reputation of the business and the period of operation;
- target market;
- diversity;
- the relative strengths of the business;
- the general economic climate in retail.

Despite the introduction of ecommerce and internet banking the POSTshop is a unique retail outlet. With regard to the factors listed above our preliminary assessment of the EBIT multiple would be between 3.5 to 4.5 excluding other capital charges eg. Franchise Fee and stock.

- Franchise fee:

The franchise will also pay an initial once off franchise application fee. The application fee should cover Australia Post administration and legal costs in establishing the franchise system. A fee of [redacted] would tend towards the higher end of the franchise fee scale. We do not think the franchise fee is unreasonable. Australia Post has a very strong brand and this supports a fee of this level.

It has been suggested that Australia Post should share in any subsequent resale by a franchisee. We believe that this is unwise in a fixed term agreement as it is a disincentive to franchisees to build the business. A franchise renewal fee would be more appropriate. This relates to our experience with many franchise chains. A franchise renewal fee would be negotiated at the end of ten years taking into account increases in cost.

- Stock:

  It is intended that stock cost and ownership should be passed to the franchisee. Stock ownership by the franchisee is most common within the franchise industry.

<u>Ongoing Fees:</u>

- Technology levy:

  The technology levy of $7,500 per terminal was set having regard to the internal transfer price determined by Australia Posts Information Technology department. The levy appears high in comparison to industry standards. An independent review of the correct transfer price should be undertaken to determine an equitable price per terminal.

- Training Fees:

  Training fees will depend on the training model undertaken. It is proposed that training should be provided using the OPSS system currently in place for Corporates and LPOs. This program has not been fully documented or tested at the time of this report. It is understood that this will happen by the conclusion of the pilots.

  Alternatively, the model described by HR dimensions in June 1999 a per person training cost of $6,000 - $10,000 would be appropriate given the depth of training required.

  Initial training would take place over 12 weeks. Training fees would be passed on in full to the franchisees as part of the cost of human resources.

- Rent:

  Actual accommodation / rental including a management fee is recovered via a levy. It is best practice to keep the calculation of rent simple. A profit is not usually made in charging rent. Any cost savings that can be negotiated by Australia Post should be passed on in full to the franchisee.

- Advertising Levy:

  The advertising levy as originally proposed is based on a percentage of Gross Profit not Sales. Best practice indicates a levy of between 2% to 3% of sales. The appropriate levy for this business is difficult to determine at this stage. The quantum of the levy requires further investigation.

  It is our view that an advertising levy should be separately maintained. This allows franchisees, by way of committee, to have some input into advertising that is carried out. Australia Post would retain rights to the final decision on any advertising proposal. It would not be appropriate to charge an advertising levy until franchising reaches critical mass.

- Ongoing Franchise Fee:

  The quantum of any franchise fee should be determined independently based on the actual franchise scenario . The fee should reflect the desired outcome in terms of profitability to the franchisee and profitability to Australia Post.

  A franchise fee of 30% has been proposed. Industry royalty charges include:

| Franchise | Royalty Charge |
|---|---|
| [redacted] | [redacted] of gross profits |
| [redacted] | [redacted] royalty and [redacted] advertising levy |
| [redacted] | [redacted] royalty and [redacted] advertising levy |
| [redacted] | rental of [redacted] - [redacted] (depending upon turnover) and [redacted] royalty |
| [redacted] | [redacted] royalty and [redacted] advertising levy |
| [redacted] | [redacted] royalty and [redacted] advertising levy |
| [redacted] | [redacted] royalty and [redacted] advertising levy |
| [redacted] | [redacted] royalty |
| [redacted] | [redacted] royalty |

If a royalty were applied to sales of franchises there would be significant variations from outlet to outlet. The mix of low margin and high margin sales and commissions vary significantly between the outlets. Instead the franchise fee is based on gross profit which is a more appropriate base.

The most comparable example from the above list is the [redacted] fee of [redacted] as this is a fee levied on gross profits. Other franchises listed charge a royalty based on sales turnover. Australia Post fee is somewhat lower than [redacted] because Australia Post charges separate levies on technology, advertising and rent.

We understand that there is a view that different size fees should be given to different size outlets. We believe that such a tiered structure would lead to unnecessary complexity and inequity in the channel. A franchise must be able to generate an adequate rate of return in its own right. Clear consideration must be given to the individual outlets stand alone profitability prior to the granting of franchises.

The ongoing franchisee fee charged will be highly dependent on achieving the correct pricing structure for commission based products. Australia Post must ensure that the fee per transaction items a franchisee is paid for, are correctly priced. The profit achieved is dependent upon the correct transfer prices. Following this the franchisee fee is based on a return on gross profit. The correct pricing structure must be ascertained prior to calculating the appropriate franchise fee.

### 4.4.2 Franchisee Profile

The franchisee profile as described by HR Dimensions fits with expected standards commonly found in franchise formats. We agree that this framework should result in the selection of appropriate franchisees.

### 4.4.3 Franchise Territory

The franchise territory specifications are based on sites rather than geographical locations. It is not possible for franchisees to have rights to customers in a geographic area. It is however possible to grant franchise rights to a territory rather than just a site. Legally the courts are currently considering whether a franchisee territory can exist within the four walls of the premise.

The value of the franchise will be maximised in the view of the franchisee if a geographical area is specified and this will in turn maximise the capital value of the franchise to Australia Post. Further there is enhanced sustainability of profit to the franchisee if a geographic area is defined as issues of competition are mitigated.

Our view is that a territory should be defined in the agreement although there is no need to make it a large territory.

### 4.4.4 Franchise Agreement

The franchise agreement is very comprehensive. The agreement is an evolving document that will change as policy decisions are made. Although we do not disagree with the factual correctness of the agreement, best practice would suggest that a more simplified, shorter document is recommended.

## 4.5 Outcome

We believe that the foundations of the concept are sound subject to the comments above particularly in regard to the agreement, goodwill and stand alone profitability.

## 4.6 Recommendations

We recommend that the model be fully developed to ensure that Australia Post's objectives are clearly met. The internal transfer fees and ongoing franchise fee require review to ensure that the franchise meets the financial decision criteria. (see further our comments at 6.3).

Our key recommendations are therefore as follows:

1. The preliminary assessment of the EBIT multiple for calculation of goodwill would be between 3.5 to 4.5.

2. We believe a sharing in goodwill on assignment is unwise in a fixed term agreement for the franchisor to share in goodwill as it is a disincentive to franchisees to build the business. A franchise renewal fee would be more appropriate.

3. An independent review of the correct transfer prices should be undertaken to determine an equitable price structure.

4. The franchise agreement should contain specific clauses in regard to territory.

5. The issue of competition by Australia Post will also need to be addressed.

6. We believe that the foundations of the concept are sound subject to the comments above particularly in regard to the agreement, goodwill and stand alone profitability.

# 5. Pilot Sites Analysis

## 5.1 Report on the Feasibility of the Concept

Australia Post's objective in conducting the pilots was to:

- Validate or improve the proposed franchise POSTshop format that has been developed including reality tests of desktop Profit and Loss projections.

The objective of this section of the report is to see whether the philosophy of the pilots was correct and whether there were any limitations.

Where limitations were identified they were analysed in respect of their impact on the pilot results to fit into one of the following three categories:

- Critical to undermining the success of the pilots.
- Critical but lead to continuation of the pilots.
- The effect is not material to the pilot.

The pilot sites were established in four locations as follows:

| Location | State |
|---|---|
| Bacchus Marsh | Victoria |
| Green Valley | NSW |
| Chullora | NSW |
| Mortdale | NSW |

With the exception of the Chullora POSTshop they replaced existing post outlets in those areas. Each shop was set up in the new POSTshop format being undertaken as part of Australia Post's branding philosophy.

Each of the franchisees were chosen by the States and had all previously been licenced post office owners.

Bacchus March, Green Valley and Chullora stores were set up in shopping centres. The Mortdale store is located in a street front shopping strip.

A comparison is made at Appendix A of the different attributes of the four sites.

The pilots commenced on the 4th October 1999 with the exception of Chullora which happened later because of the unavailability of the site.

There were some limitations in the pilots conducted:-

1. Selection Criteria:

   We are unable to determine whether the selection process for franchisees is appropriate as a result of the pilots conducted. The franchisees of the pilot sites did not necessarily represent the required characteristics of a franchisee. Selection criteria is difficult to test until final rollout when advertising and interviews can be conducted in the marketplace. This is a limitation inherent in any pilot.

2. Risk / Reward:

   It is difficult to assess the franchisee's behaviour as there was limited risk undertaken by them. This issue is extremely common in pilot sites. Although there was a reward mechanism this will not always provide enough incentive. The reward is also paid on a delayed basis thus there is no immediate consequence of behaviour undertaken. This is a difficulty often inherent in running a pilot. To achieve a balance between risk and reward in a short term period has many associated complex issues. Often the reward may be overcompensated in comparison to the risk in order to attract people to the pilot.

3. Timing:

   The pilot sites were established within a very short period of time (ie from decision to implementation). Therefore initial problems and ill feelings that occurred were difficult to dispel as the pilots continued.

Other Limitations:

Other limitations were identified in regard to image, location, period of analysis, training, transfer pricing, stock and communication.

In Conclusion:

In conducting a pilot ideally there would be a control site as well as sites where adjustments to the franchise model can be tested. A similar site operated as a corporate office and another operated as a LPO could have been identified and run alongside the pilots to provide comparison for all facets of testing.

## 5.2 Pilot Results

We have conducted a quantitative and qualitative review based on the decision criteria outlined at 4.2. Attached at Appendix B is a summary of quantitative and qualitative data we were able to measure. As the desired outcomes were not established at the commencement of the pilot trials few mechanisms have been set up by which we can reliably collect the data required to support the decision criteria. The financial results at the pilot sites are currently being measured and more accurate financial data will be available at the end of the pilot period. As the current financial analysis is unreliable most of the analysis to date has been performed on a qualitative basis.

Several studies are currently being conducted to gather information to facilitate analysis at the end of the pilots.

### 5.2.1 Financial Performance

The franchisees to date have not been involved in compiling and analysing the financial data. They are currently receiving statements 3 to 4 weeks after the end of the month advising them of the income earned and franchise fees paid for the month. No budgets have yet been established in order that the franchisees can monitor their performance. The franchisees are drawing $3,000 per week to cover staff costs and operational costs. Most of the franchisees feel that this is sufficient. It may not be possible to repay a business loan on this level of drawings, however we are unable to confirm this from the information available at the time of this report.

1. Stock:

   The franchisees have not paid for stock up front. Stock is sent to them in accordance with merchandising plans, push orders and re-order from the franchise. The franchisees do not understand how the margins are calculated therefore they have no ability to manipulate sales to high margin areas. The fact that there is no stock ownership in the pilots is a concern for many stakeholders in that they feel there is not a sufficient interest in stock and therefore stock handling by the franchisees is not as efficient as it could be ie. franchisees are overstocked because there is no cost burden to them of holding inappropriate stock levels.

2. Technology fees:

   The pilot franchisees view is that it is Australia Post systems software that they are being required to fit in with. Thus they feel that they are taking on an Australia Post overhead to their business. The franchisees believe that if Australia Post require the franchise to use that software then there should be a subsidy on that equipment. Accordingly the franchisees feel that they are being overcharged for technology.

However, it should be noted that the Information Technology Department actually charges $9,500 for provision of the computers. More accurate transfer pricing studies must be conducted either by an objective internal assessment or an external adviser. Economies of scale should be realised on roll out.

3. Goodwill:

Comments in regard to a possible up front fee of approximately [redacted] received a negative reaction. The franchisees felt that for that outlay they would want a return on the goodwill at expiry. Otherwise the cost was seen as a right to self fund their own salary.

Our comments at 4.4.4 show how an EBIT model can be used to arrive at an assessment of goodwill, however this would still be subject to testing in the market place. Due to the strong brand name we believe an EBIT multiple between 3.5 to 4.5 is justified.

Further we believe that for Australia Post to share in the goodwill would be unwise in a fixed term agreement as it is a disincentive to franchisees to build the business. It would be more appropriate to incorporate a franchise renewal fee that would be negotiated separately at each site.

4. Transfer fees:

The margin received on cost of goods sold was seen by franchisees to be low relative to prices charged by wholesalers outside of Australia Post. The gross profit calculated at Appendix B would seem to be comparably higher at [redacted] than typical newsagency margins however this calculation does not take into account the cost of goods included in opening inventory. After consideration of opening inventory preliminary estimates show a gross margin of approximately 29% which appears to be more realistic.

5. Net profit return:

The net profit return to franchisees shown at Appendix B varies across the outlets. These are preliminary figures only as Profit and Loss was not monitored continually throughout the pilot. More accurate data should be available at the end of March 2000.

6. Financial return to the franchisee:

The initial franchise term is for a five year period and during this time the franchisee draws a standard managers salary and recoups their initial investment at a rate of [redacted] per annum. Assuming that the franchisee meets performance expectations it will take approximately 5 years for the franchisee to break even on the initial capital investment. Once the franchisee breaks even on their investment, the [redacted] return per annum constitutes profit to the franchisee.

The franchisee financial models have been based upon overhead costs incurred to date by the pilot studies. A full year's results projection is necessary to estimate the future sustainable income.

7. Financial return to Australia Post:

Based on a [redacted] profit share to Australia Post as calculated in the financial model at Appendix C the return on assets to Australia Post is between [redacted]. Again the franchise sites more closely resembling the characteristics chosen for the ideal franchise site are the better performers. This may not be sustainable across a broad band of franchise sites.

### 5.2.2 Customer Service Standards

Limited measurement was conducted by TMG of customer service standards in November 1999. The results show that the franchise outlets were performing better than state averages in customer service standards.

Customers are happier with the extended trading hours on a Saturday, however the franchises do not really feel that it is cost effective to open on a Saturday. No quantitative study has been conducted yet into the cost benefit analysis of Saturday training.

We understand that studies are currently being conducted by OMNA and TMG in regard to customer service standards. This information is not available at the time of preparing this report. As no control site analysis has been performed for comparative purposes such as a Corporately run POSTshop, it is difficult to determine to what extent the favourable reaction can be attributed to the POSTshop format in general rather than specifically to the franchisee model.

TMG are undertaking Mystery Shopouts at 425 sites during February and March. In addition the franchised POSTshops are being shopped out each two weeks. By the end of March there will be sufficient data to evaluate the quality of customer service provided at the franchises. In regard to compliance Omna have commenced fortnightly measurements of the four franchised POSTshops and four corporate POSTshops (with similar characteristics) and the information gleaned from these should be sufficient to draw conclusions.

Customer Waiting Time:

Customer waiting time has not been measured, however anecdotal evidence from the franchisees suggests that customers feel that they are spending less time in queues.

Post Office Boxes:

Post office box sorting times are largely dependent on the number of boxes let. No records have been kept however the franchisees claim to have sorted the mail on the majority of occasions by 9:00am. On some occasions mail sorting is not completed until 9:30am. According to the franchisees this is usually due to incorrect addresses. We understand that sorting times are now being recorded however, no information was available at the time of this report.

### 5.2.3 Support Requirements and Costs

The franchisees are generally happy with the level of support they are receiving from Australia Post. However, the franchisees are all from Licenced Post Offices and are used to a minimum of support.

The area identified as requiring the most additional support is stock. The franchisees (with an LPO background) are not familiar at all with the Australia Post merchandising systems.

All franchisees felt they were receiving good support from the area managers however the area managers were not empowered enough to solve their problems. The area managers encountered problems with internal service providers not being responsive to the issues raised.

A dedicated area manager was made available to the three pilot franchisees in NSW. The area managers of the franchises should have the ability to direct the support functions as to the requirements of the franchises. Some of the areas in which the area manager was unable to resolve a franchisees problems included:-

- Delays in the provision of signage.
- Delays in the provision of display cases.
- Delays in obtaining adequate supplies of stock.
- Problems associated with the National Stock Master File and EPOS.
- Advice regarding price changes.
- Changed ticketing

These areas will need to be resolved both on a State and a National Level as to responsibility and timely resolution. Although these may be common problems for Corporate POSTshops, a franchisee structure will not tolerate problems and delays of this nature.

A majority of the support functions that are proposed under the franchise model were not available to the pilot franchisees. This includes support regarding advertising, training and profitability.

Apart from the high cost of technology the franchisees were generally satisfied with the technology support received from the help desk.

### 5.2.4 Training Systems

The franchisees believe that hey have received little training to date. Two days were spent with the franchisees explaining the concept and operational aspects of the franchise pilot. A needs analysis was conducted and as a result it was determined that the franchisees needed further training in stock and merchandising systems. Half a day was spent with each franchisee in regard to stock management. None of the franchisees felt that this was sufficient. This area requires more in depth training.

The franchisees would generally prefer on the job training than external training. Corporate managers were provided as mentors for the first two weeks of the pilots at Bacchus Marsh, Green Valley and Chullora. As the franchisees were still settling in at this time there were many distractions and they were unable to take on a shadowing role. The provision of an on site buddy system is appropriate however it would have been of more assistance in say the fourth and fifth week once the franchisees had better established themselves.

The proposal by HR Dimensions in June 1999 outlines a comprehensive training system for new franchisees. We understand that there is a preference by the franchise team to use the existing internal OPSS system however the exact specifications of how this would be applied to franchisees has not yet been formulated and we are unable to assess its appropriateness at this time. The franchisees would favour the OPSS system as it is often training which can be conducted with little/ no interruption to their operations.

### 5.2.5 Simplified Payment System

The franchisees do not agree that the payment system is simple. They have no understanding of transfer prices used. Franchisees are unable to manipulate trading results to higher fee services because they are not aware of how fees are calculated.

There has been much conjecture at a State and National level over transfer prices however, all of the evidence of this to date is anecdotal.

We would recommend a review of the transfer pricing in order that the payment structure can be justified and this will lead to a more accurate calculation of the franchise fee. The more accurate this calculation is the more sustainable it will be in the longer term.

### 5.2.6 Selection Process / Compliance

There was no formal selection process for the pilots. State Management selected participants for the specific locations. The level of compliance displayed by the franchisees is moderate/high. However, they all have an LPO background and are used to operating in a non compliant highly entrepreneurial environment. As problems have occurred which have no documented solutions, franchisees have compromised and come up with their own solutions. The franchisees did not receive some of the documentation such as the POSTshop manual and franchise agreement until well after the pilots had commenced. The POSTshop manual was generally not complied with by either party during the pilot.

### 5.2.7 Management Support

Due to the background of the pilot franchisees selected very little management support was expected. Two areas which have been identified as requiring additional support are:

- stock management; and
- financial performance.

When questioned about other support requirements franchisees identified the following areas:

Advertising:

A requirement for pre approved bromides for participation in local advertising in catalogues such as whole of centre advertising.

Training:

Would prefer on the job training by way of a buddy system.

Area Manager:

Should have authority and ability to solve sundry problems encountered by the franchisees. Control should be centralised through the area manager.

Australia Post was not well equipped to deal with the issues arising from franchises. This is mainly due to a lack of communication of how the franchise system was to operate. Procedures had not been put in place to enable various divisions to deal with the franchises. Instead people adapted by treating them as an LPO in areas such as stock management or corporates for the purpose of fitouts and training.

## 5.3 Results Measured

The major objective in conducting these pilots was to validate or improve the proposed POSTshop format that has been developed including reality tests of desktop profit and loss projections.

We believe that theoretically the franchise model developed should give rise to a franchisable product. The results measured in line with the decision criteria established shows that support functions have been or are in the process of being developed in order to fully support the franchise concept.

At the time of this report there was insufficient data available to accurately measure customer service standards and financial performance. However there are now mechanisms in place in order to capture the relevant data by the end of the pilots. We believe that analysis of the data at the end of the six month period will be more relevant to assessing the success of the pilots than the limited data available at the end of the initial three months when the pilots were still undergoing their set up period.

The support functions provided by Australia Post will need greater attention in order to streamline functions on final rollout. It is our opinion that all support functions should be co-ordinated via a centralised franchise support team to ensure that the needs of the franchisees are met with the minimum of follow up required by the franchisee. The requests should be centrally managed by the support team.

The training system is still being developed and documented and should be completed by the end of the pilots. It has been proposed that training will be run in line with the current OPSS system and therefore should be integrated into the franchise system with relative ease.

As stated in our earlier comments regarding the limitations encountered when conducting a pilot the selection process is difficult to test in a franchise pilot. However we believe that the criteria developed should give rise to the correct selection of a suitable franchisee.

In regard to management support there are some outstanding issues in regard to the level of advertising support to be provided and merchandising support. When a critical mass of franchised outlets is reached these functions will become more important. The critical issues can be addressed through training and communication of issues which relate to franchisees.

We believe that continuation of the pilots is necessary to fully test all aspects of the franchise concept. The format must continue to be run at the four sites while the results to March 2000 are being evaluated and a recommendation is made as to the future of franchising.

If the results to March substantiate this model Australia Post may wish to test this theory further by way of a limited roll out. If franchise agreements were offered in only one State to a limited number of sites this model could still be developed and tested before the final format is decided.

# 6. Pilot Sites Results Compared

The following section compares the results achieved under three different desktop models:-

- A Licenced Post Office.
- The standard franchise model.
- An adjusted franchise model

The comparison is made firstly from a qualitative analysis then secondly by reference to financial models prepared. It is not possible to prove the desktop models against the pilot results at this stage however, more information will be available by the end of the pilots.

## 6.1 LPO'S (Option 1)

### 6.1.1 Outline

The LPO structure is the structure used by Australia Post.

The LPO structure has been criticised for the following reasons:

1. Poor image.
2. Lack of compliance with Australia Post requirements.
3. No fixed term.
4. Australia Post unable to share in goodwill generated.
5. Complex commission structure open to manipulation.

### 6.1.2 Financial Assessment

The Licenced Post Office run in its current format as an in conjunction newsagency outlet should produce results in line with Appendix C (i). The total profit achieved at the outlet is [redacted] This is split between the Licencee and Australia Post [redacted] respectively. Cost reductions can be attributed to fitout costs as the fitout of a LPO is not as extravagant as a POSTshop.

Appendix C (ii) assumes a Licenced Post office run in a POSTshop format. This model assumes a larger floor space is required and the fitout is in keeping with a standard POSTshop. Costs have increased accordingly and the LPO is no longer profitable to the licencee in its own right. This is because the franchisee is responsible for all of the increased accommodation costs.

## 6.2 Franchise the POSTshop Sites (Option 2)

### 6.2.1 Outline

The detailed design of the franchise business model is explained at 4.3. The key objectives of the proposed format include:-

- Growing the business;
- Reducing costs;
- The provision of better customer service standards; and
- Rectifying some of the problems identified at an LPO such as granting the franchise for a fixed term.

### 6.2.2 Financial Assessment

Appendix C (iii) illustrates the financial return achieved in a franchised POSTshop format. It is assumed that there will be an increase in total revenue due to the enthusiastic franchisee behaviour. However, this estimated increase has been calculated conservatively for the purposes of this model. Total profit generated by this model is [redacted] which is split [redacted] Australia Post [redacted] franchisee.

## 6.3 Adjustments to Pilot Franchise Model (Option 3)

### 6.3.1 Outline

Adjustments we would recommend to the franchise model would be to the Franchisee Fee and to the calculation of Goodwill.

Based on the current transfer prices a franchise fee of [redacted] would appear to be a more equitable split of profits between Australia Post and the franchisee.

The EBIT Multiple of [redacted] may be a little high based on the expectations of the impact deregulation and e-commerce will have on the POSTshop. For the purposes of this model we have assumed an EBIT multiple of 4.

### 6.3.2 Financial Assessment

By increasing the franchise fee to 40% and increasing the Return on Investment to the franchisee to [redacted] Australia Post would achieve a return on assets of [redacted] and retain a larger share of the overall profits. The franchise model is now as profitable to Australia Post as the LPO model.

This effectively redistributes the profit earning potential of the model. Australia Post has a larger income share and a lesser capital share. This is traditionally the case in a franchise where the franchisor does not expect to share in the goodwill generated at the expiry of the franchise term.

# Appendices

## Appendix A

| | State | Location | Franchisee Background | Opening Hours |
|---|---|---|---|---|
| Bacchus Marsh | Victoria | Shopping centre | Licenced Post Office | 9 - 5 Monday - Friday<br>9 - 12 Saturday |
| Green Valley | New South Wales | Shopping centre | Licenced Post Office | 9 - 5 Monday - Friday<br>9 - 12 Saturday |
| Chullora | New South Wales | Shopping centre | Licenced Post Office | 9 - 5 Monday - Friday<br>9 - 12 Saturday |
| Mortdale | New South Wales | Street front shopping | Licenced Post Office | 9 - 5 Monday - Friday<br>9 - 12 Saturday |

**THESE PAGES HAVE BEEN REMOVED:**

- APPENDIX B (4 pages)
- APPENDIX C – INDEX (1 page)
- APPENDIX C(I) (1 page)
- APPENDIX C(ii) (1 page)
- APPENDIX C(iii) (1 page)