

Foodco Public Submission

Parliamentary Inquiry into the Operation and Effectiveness of the Franchising Code of Conduct

21 August 2018





Introduction and observations

Foodco Group Pty Ltd (Foodco) welcomes the opportunity to make a public submission into the operation and effectiveness of the Franchise Code of Conduct (the Code).

In making this submission we believe it is important to recognize the contribution that the franchising industry makes to the Australian economy and that any regulatory improvements must strike the right balance between the Code which provides protection for prospective and existing franchisees, and the rights of individual businesses to operate freely in a market that creates jobs and consumer choice through competition, innovation and entrepreneurship.

Over the years there have been several reviews and changes to the Code and despite these changes we continue to discuss the effectiveness of the Code and seek solutions to try and prevent franchise failures through Code improvements. History has demonstrated that the process of simply focusing on changes to the Code to minimize failure is fundamentally flawed. Indeed, our experience in the United Kingdom and New Zealand which have no mandatory franchising code of conduct, is that disputes and failure are less common than they are in Australia. The committee should consider that perhaps the solution does not rest solely with Code improvements via more disclosure obligations but in areas outside the Code.

Foodco believes that whilst some improvements can be made to the effectiveness of the Code and/or provide clarity to some obligations within the Code to help franchisees better understand and hopefully minimise the risk associated with small business, the major contributing factors to franchisee failure within the retail food sector are outside of the franchisee/ franchisor relationship and can be attributed to the following factors:

1. Economic conditions affecting small business generally; for example, rising electricity cost, rapidly increasing rentals in excess of CPI, penalty rates and changes to the competitive landscape that make it increasingly difficult for small businesses to compete effectively.
2. The conduct of the owners of major shopping centres and the need for legislative reform to protect franchisees and franchisors from unfair conduct and abuse of market power.
3. Structural change in the way consumers shop which has changed the focus of shopping centres from one of apparel to one of food, hospitality and experience. This has meant a significant increase in competition for existing food retailers resulting in a reduction in top line sales during a period of increasing operational costs. Consequently, this has led to an increase in retail failures

As a consequence of the above factors, we have seen significant margin squeeze in business profitability.

Franchisee failures in the retail food space have increased and as a result disputes between franchisees/franchisors have increased. Greg Nathan's submission number 47 does an excellent job of expressing the complex nature of the franchisor/franchisee relationship, and the external factors that are affecting that relationship.

The past 2 years has also seen the following large national retailers go into liquidation: Toys'R'Us, Dick Smith, Topshop, Pumpkin Patch, Payless Shoes, Marcs, David Lawrence, Herringbone, Rhodes & Beckett, Orotan, Live Clothing and Maggie T. Other retailers such as Esprit have pulled out of the Australian market. Further, the large department stores which for years have been the cornerstones of shopping centers are also experiencing serious declines



in profitability. This is indicative of the very difficult retail and economic climate that currently exists. It is important to note that these national retailers are not franchise chains.

We believe that overall the Code is sufficiently comprehensive and strikes a fair balance, and, coupled with the provisions of the Competition and Consumer Act 2010, is an effective way to prevent exploitation by franchisors without discouraging the franchise business model and entrepreneurship in Australia.

1. About Foodco

Foodco is a family owned business and not publicly listed. Foodco commenced operation in Australia in 1989 with the first Muffin Break opening in Coolangatta, Queensland, as a family run café. From there it began its journey following a strong tradition of family values. Foodco now has approximately 330 franchised business retail outlets trading through the Muffin Break bakery café franchise and Jamaica Blue contemporary café franchise in Australia. In 2001, Foodco expanded into international territories and has grown its offshore network to approximately 140 stores operating in 6 countries. Our franchisees are small businesses located across every State and Territory and play an important role in regional centres.

Foodco operates its support office at The Entertainment Quarter in Sydney, incorporating a state-of-the-art hospitality training facility. Foodco directly employs more than 140 people. Our national franchise network engages approximately 2,400 staff on a permanent/casual basis.

Foodco is very proud that over the past 29 years we have enabled many hardworking entrepreneurial Australians and New Zealanders to be self-employed and achieve their business goals. As a testament to our strong relationship with our franchisees, 40 franchisees have been part of Foodco Australia and New Zealand for 10 years or more. We are committed to being an active contributor in our local communities and help to raise awareness and much needed support to valuable charities such as Sydney Children's Hospital Foundation, The McGrath Foundation, Share the Dignity, and The Beacon Foundation.

Muffin Break was awarded the Roy Morgan Coffee Shop of the Year for the past two consecutive years. Jamaica Blue was also named Golden Bean - Large Franchise Coffee Champion of the Year in 2017. Both Muffin Break and Jamaica Blue franchisees have also won several other State and regional retail hospitality awards.

2. Franchise Models

Retail food chains operate differently. Foodco operates a very different business franchise model from some other franchisors. For example, Foodco has no 'central kitchen' concept. Muffin Break franchisees bake all their food on-site and the majority of the Jamaica Blue menu is prepared and cooked on-site.

Franchisees of Muffin Break and Jamaica Blue are permitted to source many goods from alternate suppliers if the goods are of equal quality to those of our recommended suppliers. We actively encourage this practice where the franchisee can source a better price for the same or similar products. Foodco of course does require some products such as proprietary muffin mix and coffee beans to be purchased from our approved suppliers to ensure a high-quality product and product/brand consistency. Foodco is confident that the prices charged for coffee beans are competitive and the prices are inclusive of a bi-annual maintenance and service program on franchisee's coffee machines and grinders.

3. Selection of Franchisees

Foodco undertakes an extensive recruitment process. All prospective franchisees are required to complete a detailed application form and attend an interview. During the interview process, prospective franchisees are advised that all business opportunities have inherent



risks and that despite the franchisor's best intentions, success cannot be assured. Foodco also advises prospective franchisees that it cannot give any assurances in respect of expected sales, profitability or revenue of the franchised business. Prospective franchisees are encouraged to undertake their own due diligence and obtain independent legal, accounting and business advice.

In the case of a shop transfer (sale), whilst Foodco undertakes the process outlined above, Foodco leaves the negotiations concerning the sale of the business to the existing franchisee owner and the prospective purchaser. Foodco does not act as a business broking agent and is not licensed to do so. Foodco does not act for either party in the sale transaction as to do so may result in a conflict of interest.

4. Foodco leasing arrangements - current retail issues

Foodco (through its Related Companies, Muffin Break Pty Ltd and Jamaica Blue Pty Ltd) is the lessee of the vast majority of its franchised sites nationally. This is a significant financial commitment by Foodco and something it takes very seriously. We understand that many franchisors in the retail food sector do not hold the lease, and the lease liability rests solely with the franchisee.

A franchisee who is not successful and unable to pay their rent creates an immediate liability for Foodco. Any suggestion that Foodco deliberately sets up a franchisee for failure or engages in conduct that may make a franchisee unprofitable is unfounded and contrary to our financial position as lessee. In the event a lease is surrendered, Foodco, not the franchisee, pays the surrender fee which could be anywhere between \$30,000 and \$250,000 depending on the remaining term of the lease. Foodco often does not pursue the franchisee for these fees.

Successful franchisees have been the key to Foodco's ability to expand its network to approximately 330 locations nationally.

Foodco does not shy away from the fact that there have been franchisee failures and unfortunately in the retail sector, failures do occur for various reasons. Where Foodco believes it could have done more to attempt to avoid a franchisee's failure, or events have occurred beyond the franchisee and/or our control, we endeavor to assist the franchisee by offering additional support to that franchisee. At times, this has seen us purchase a business back from a franchisee at well above fair market value or offer the franchisee significant financial concessions. However, and regrettably, there are numerous situations where failure is solely at the hands of the franchisee.

In recent years, Foodco considers that lessors have been a major contributor to retail failure and the closure of stores which franchisees have operated for many years. Whilst Foodco considers it has a strong relationship with most major shopping centre lessors in Australia, the power imbalance is real and at times leads to uncommercial and/or unviable situations in an effort to remain at a location.

By way of example, Foodco has seen some lessors, without consultation, grant leases to retail competitors of our brands in close proximity to our existing franchisee's cafés. To compound matters, in recent times, these competitors have been offered rent at a price significantly less than the rent we (and our franchisees) are obliged to pay and are also offered lucrative capital contributions to assist with fit-out costs. Matters often become worse at renewal when some lessors seek to increase the current rent, require a significant refurbishment, yet offer no capital contribution to assist the franchisee. Under the current retail legislation in Australia there is no compensation in situations where the actions of the lessor with regards to centre usage management have significantly impacted the financial viability of the existing retailer. We have also seen numerous examples where shopping centres have undergone significant redevelopment which has caused significant loss of trade for those retailers at the centre both whilst the redevelopment occurred and post the redevelopment.



Margins in retail food are reasonably modest and any significant change to existing rental obligations is critical to the on-going viability of a business. Furthermore, in recent years margins have come under even greater pressure through increased labour costs and significant increases in operating expenses such as electricity costs. In some cases, Foodco has assessed the lessor's renewal position as commercially untenable and likely to force the franchisee into insolvency. In those cases, Foodco has had to inform franchisees that it cannot in good faith renew the lease and thereby expose the franchisee and ourselves to significant financial risk. Foodco does of course work together with the franchisee when such a situation arises, which may include options about relocation, or allowing the franchisee to end the franchise and seek to trade independently if they are adamant about remaining at the same location. Unfortunately, lessors are often not prepared to deal with a former franchisee on an independent basis and there is nothing Foodco can do in those situations.

5. Rebates and purchase of products

The payment of rebates to any retailer (including a franchisor) is reasonably common. Foodco does receive modest rebates from some of its suppliers. The main suppliers who provide a rebate are disclosed in our Disclosure Document as required by the Code. The suggestion that we are secretive about rebates or that we are obtaining a lucrative financial gain is simply incorrect.

Rebates subsidize our network national conferences, advertising programs, procurement and new product development function, all of which are designed to benefit our franchisees.

The Foodco conference is an important event held over four days. Whilst suppliers play a part in the conference, the major focus of the conference is skill training, education and motivation. Importantly, the conference also enables our franchisees to network amongst themselves and to take valuable time away from their businesses to relax and rejuvenate. The conference includes a formal awards night where we recognize the outstanding achievers within our networks. The conference is well attended, and many franchisees take the opportunity to bring their families. To accommodate this, kids' clubs and special activities are arranged. The cost of the conference is covered by a combination of rebates, Foodco and franchisee contributions.

Foodco's primary focus when negotiating with its suppliers is to achieve the best value (price and quality) whilst maintaining a competitive cost of goods for our franchisees. The payment of a separate rebate is not our focus. Negotiations with suppliers are based on volume. The greater our volume the better our negotiating position with any supplier. However, suppliers are not always able to guarantee us their lowest price as they often have other customers with larger volumes. For example, we will never be able to compete with the likes of Coles or Woolworths on volume or price. Therefore, we actively encourage our franchisees to constantly monitor food product prices (such as for milk, dairy products and cooking oil) and purchase such products at the best price they can obtain. Our franchise agreement expressly allows a franchisee to purchase non-branded supplies that are equal in quality and cheaper in price than those provided by our recommended suppliers.

6. Advertising Fund

Our marketing fund is audited annually as required by the Code and copies of the audited statement are made available to all franchisees. Furthermore, the marketing programs are reviewed and approved by a committee made up of franchisees from each State who meet regularly and report back to the wider franchisee community.

7. Meeting of Franchisees

In addition to the marketing meetings referred to above, Foodco, through Muffin Break and Jamaica Blue, hold regular meetings with its franchisees throughout Australia. State based group meetings are held approximately 2-4 times per year.



Workshops and other training events are held periodically which focus on retail priorities such as service, food quality and customer service standards.

In addition to meetings and workshops, all franchisees have access to an online portal which they are encouraged to log into weekly to ensure they stay up to date with required training and information that impacts their businesses.

Foodco monitors franchisee engagement by appointing external companies to conduct anonymous surveys of its franchisees. Our last survey conducted in October 2016, showed that both our brands, in the area of practical support, training, systems and innovation ("Business Model"), scored higher than the industry benchmark for satisfaction. The resulting output to a series of questions showed that the overwhelming majority of Jamaica Blue franchisees and Muffin Break franchisees agreed or strongly agreed that there is a proven Business Model.

8. ACCC approval and Fair Work Ombudsman (FWO)

Foodco has over the years obtained the approval of the ACCC in respect of third line forcing arrangements for food suppliers and IT/software providers for products required to be purchased and used in the operation of Muffin Break and Jamaica Blue franchises. These are all a matter of public record and have been approved by the ACCC based on the stated competitive benefits.

In addition to ACCC approval for third party supplier arrangements, Foodco entered into a voluntary proactive compliance deed with FWO in January 2017. Foodco did this to acknowledge the importance of ensuring that all employees within the Muffin Break and Jamaica Blue networks are paid correctly and not exploited. Foodco was one of the initial franchise systems to make a significant commitment by entering into a voluntary proactive compliance deed with FWO.

9. Response to the Terms of Reference:

Whilst we do not propose to deal with all the Terms of Reference we wish to make the following comments:

a) Likely financial performance of a franchise and worse-case scenarios:

We believe it is important to differentiate between the franchisor's responsibility in the case of a new franchisee and an existing franchisee purchasing a franchise business as a going concern.

(i) Financial performance of a greenfield site – new location:

The Code does not make it mandatory for a franchisor to give earnings data or projected earnings for a franchised business. Whilst a franchisor may elect to do so, it faces risk of liability under the Australian Consumer Law if it does not have reasonable grounds for making the financial performance representation.

If the information the franchisor provided is general in nature (in that it may cover the financial information of a franchised business within the system with greatly varying characteristics) this may lead a franchisee to form the view that the performance of the franchised business will be better than what eventuates. A requirement to provide financial information about the likely performance of a franchised business may have the opposite outcome to that intended.

Franchisors are reluctant to provide earnings information to a prospective franchisee seeking to establish a greenfield location. There are many factors outside of a franchisor's control that will affect the trading performance of a store. The single most important being the ability and motivation of the franchisee. Other unknown factors include the shopping centre's capacity to attract the necessary foot traffic, the additional competition added by the lessor which can impact trading performance, the location and performance of major retailers which may have



a detrimental effect on traffic flow, the state of the economy and consumer confidence.

A franchisor cannot give a franchisee all information necessary to make a 'fully-informed' decision and therefore a franchisee must undertake its own due diligence.

A franchisee needs to seek independent accounting/business advice to evaluate the opportunity from their financial perspective, and to prepare a business plan for the business opportunity taking into account their own financial resources, needs and expectations. The accounting advice should evaluate and consider the characteristics of the actual franchised business the franchisee intends to operate, whilst considering the general financial information provided by the franchisor as guidance.

Recommendation:

Any general information to be provided by franchisors should be restricted to information pertaining to average sales, wages, costs of goods and standard operational costs. Protection should be given to franchisors if the Code is amended to require such financial information to be given.

(ii) Sale of existing franchised businesses:

In the case of a sale of an existing franchise business where a franchise system has access to sales information, Foodco believes the franchisor should have to endorse the information provided by the existing franchisee.

Recommendation:

A franchisor should be required to verify the sales being reported and that certain cost, for example wages, cost of goods and occupancy, that are within their system parameters.

The Code should require the franchisees to provide quarterly management accounts, and separately, year-end financial statements prepared by an independent accountant with an accompanying compilation report (Reports). The franchisor should have the ability to terminate a franchise agreement if the Reports are not provided within a reasonable time required by the Code.

b) Related matters:

Shopping Centre Lessors - the imbalance of power:

We draw the committee's attention to the imbalance of power that exist in the relationship between lessors and retailers and the current challenging economic and retail environment in Australia.

The retail shopping centre landscape is one of the biggest causes of concern for franchisors and franchisees. For franchisees, it is one of the key cost side-pressures on margin squeeze/profitability with ever escalating costs in the face of flat revenues and/or price deflation in hotly contested quick service restaurant segments. For franchisors who hold the lease, it is a significant fixed operating cost that continues to escalate, making tenancy expenses a far greater proportion of turnover than comparable economies.

While franchising businesses continue to weigh up the challenges and heavy burdens that accompany being a retail shopping centre tenant, with the foot-traffic and the customer appeal that they also provide, reservations about committing to such a lease may be compounded by lessors' conduct during the lease period that can cause considerable harm.



The major issues that clearly cause substantial financial hardship for franchisees and franchisors are:

- Excessive rental increases, particularly at end of term when the tenant is at its most vulnerable.
- Abuse of market power to continually add new competitors to the shopping centre, impacting the revenue of existing tenants with no offer of rental assistance. These new competitors are attracted by better commercial terms and financial incentives not offered to the existing tenants at renewal. Lessors are under no obligation to protect the existing tenant against their decision to add extra competition.
- Lack of proper transparency and disclosure about rental rates and rebates being given by lessors to tenants within a shopping centre.
- The fit-out required by lessors on commencement of a lease or as a condition of renewal often requires a capital expenditure so great that the franchisee might not achieve a satisfactory return of their investment during the term of the lease.

The above issues are by far the biggest cause of failure of franchised businesses in major shopping centres, and in our experience the major cause of disputes between franchisor and franchisee. Too often these matters are painted as disputes between franchisor and franchisee when in fact the root cause is the conduct of lessors in retail shopping centres.

Recommendation:

- (i) Establishment of a retail tenancy code of conduct to address the imbalance of power between the lessor and lessee which includes a provision requiring the lessor to act in good faith.

The retail tenancy code of conduct should:

- a. allow tenants to exit a lease at no cost and to seek compensation when actions by the lessor have resulted in significant decline in the tenant's profitability - e.g. the addition of competitors without consideration to the impact of the existing tenant;
- b. prohibit a lessor from requiring a tenant to provide sales figures to the lessor. The lessors argue that these figures are necessary to evaluate category performance however, they are used to leverage up rentals at renewal. This information is used by the lessor to increase rentals in good times however, category performance reports are generally not available to tenants when shopping mall category sales are disadvantageous to the lessor.
- c. require lessors to demonstrate the basis for their determination of 'market rent' and make that information available to the existing tenant at time of renewals. This should include disclosure about recent rentals given by lessors to tenants. If they cannot agree on market rent, then an independent market valuation should be available.
- d. provide the existing tenant with a last right of refusal on the same commercial terms that the lessor was able to extract from the market provided the existing tenant was not in breach of the lease.



- e. require lessors to include franchisees in all discussions regarding the tenancy and in particular negotiations regarding renewals.

Franchisee Due Diligence:

Whilst a franchisee must take personal responsibility for its own financial decisions, the current Code allows the prospective franchisee to forgo legal, business and accounting advice.

Recommendation:

- (ii) Foodco believes that the Code should make it mandatory for all prospective franchisees to obtain accounting and legal advice before entering into a franchise agreement. Ideally this should be obtained from a specialist or accredited franchise lawyer or accountant. However, it should not be mandatory in the case of a renewal or extension (variation) of the term or scope of a franchise agreement.

A franchisee should be required to obtain independent legal advice to ensure they have a clear understanding of their obligations, payment requirements, end of term arrangements and the consequences for failing to comply with the terms of the franchise agreement. In addition, the legal advice should also include advice relating to the franchisee's obligations under the lease/licence agreement of the premises from which they operate their franchise business.

Foodco appreciates the opportunity to contribute to the inquiry and encourages the committee to look beyond the Code when trying to determine how best to minimise failure, not only in franchising but in small business in general. Further disclosure is not necessarily the answer.

Foodco believes that adding excessive cumbersome additional requirements to the Code will do little to address failure rate and only serve to dampen investment even further. Changes to the Code must be balanced with action to address the challenges in the small business environment and the imbalance of power that currently exists with lessors and retail tenants. Investment by Government in better education and resources to explain small business is needed. The myth that owning a small business is buying a job has to be addressed. Without this we feel little will be achieved to help address small business and franchisee failure in the future.
