Royalty models versus franchisor support

Postive Value Proposition

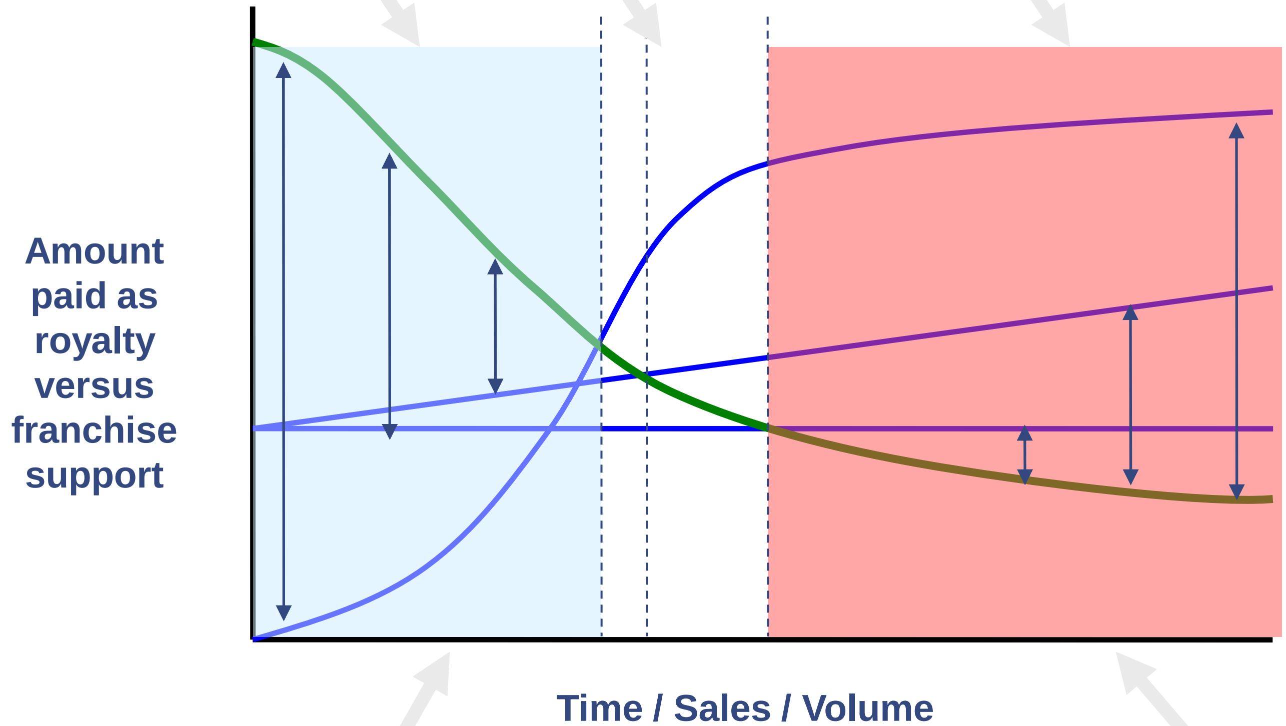
Support levels exceed royalties paid

Inversion Point

Support equals royalties paid

Negative Value Proposition

Royalties paid exceed support



Franchisee expectations set

Future support judged by this standard

Conflict Zone

Support falls below expected standard

How franchise royalty models affect franchisee satisfaction and create conflict

The idea that a franchisor's choice of royalty model can impact the long-term satisfaction of their franchisees is fundamentally based on the value-proposition of the services and support provided in return for the royalties paid.

In other words, if franchisees view royalties as a fee-for-service, then their satisfaction will inevitably decline if the level of service provided by the franchisor is not matched by the amount in royalties paid.

To better understand this concept of the value-proposition of franchise royalties, it is worth exploring the three main types of royalty models.

By definition, royalties are paid by franchisees in return for the use of the franchisor's intellectual property, trademark, and ongoing support and guidance. Mark-ups by franchisors on goods or services provided by franchisors in a distribution supply chain are not viewed as royalties for the purpose of this article.

Royalty Model 1: The Fixed Dollar Amount

The *Fixed Dollar Amount* royalty is the simplest of all franchise royalty models. It is set as a specific amount of money (eg. $100 per week) paid on a regular basis irrespective of the franchisee's business performance, or the levels of support provided by the franchisor.

This royalty model is particularly common among mobile service franchises as it requires no monitoring of franchisee performance, because whether or not the franchisee is enjoying high gross sales, the royalty remains unchanged.

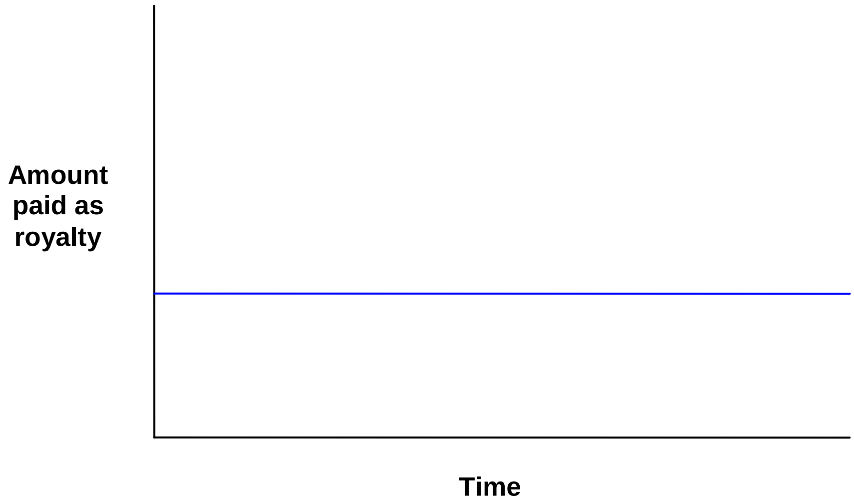


Figure 1: A graph showing the Fixed Dollar Amount method of franchise royalty over time.

Royalty Model 2: The Fixed Transaction Amount

By far the rarest of the three basic royalty models is the Fixed Transaction Amount method.

Under this method (which has much in common with the Fixed Dollar Amount royalty), franchisees are obliged to pay a dollar value equivalent to a pre-determined number of sales transactions on a regular basis.

For example, the franchisor might determine that the royalty will be the equivalent value of 10 standard services or products sold by franchisees, and charged on a weekly, fortnightly or monthly basis.

Furthermore, the franchisor recommends the price of the standard service or product, and applies the royalty accordingly, even if some franchisees charge a higher or lower price.

Again, no real monitoring of the franchisee's business performance is required because both the franchisee and the franchisor understand that the royalty will be the same from one period to the next, and applied irrespective of the franchisee's gross sales.

The number of services or products to which the Fixed Transaction Amount does not change, only the recommended price, which may increase at a rate greater than inflation due to market forces.

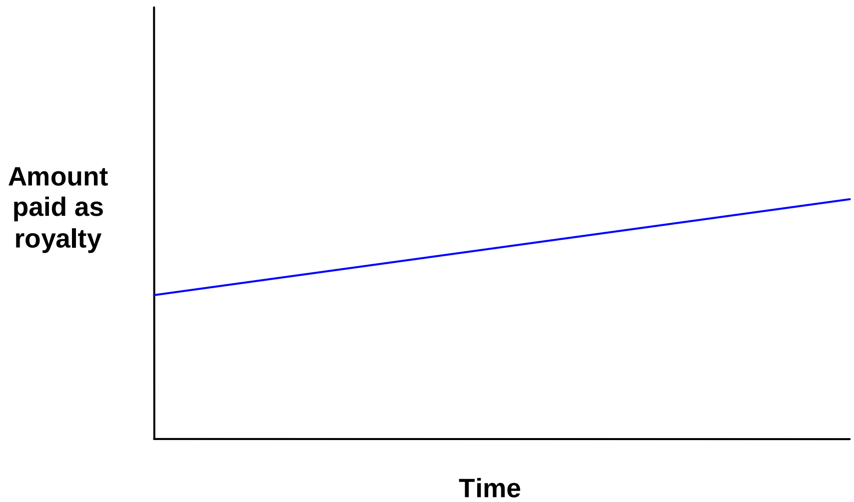


Figure 2: A graph showing the Fixed Transaction Amount method of franchise royalty over time.

Royalty Model 3: The Fixed Percentage Model

The third type of royalty is the Fixed Percentage Method, where royalties are charged as a percentage of a franchisee's gross sales. This is a common royalty in retail franchise systems.

Irrespective of the actual percentage amount (eg. 1%, 10% or greater), a graph of the royalty payable to the franchisor would appear the same as in Figure 3 for a new franchise. Initially the dollar value of the royalty is low as gross sales start to build, and then as gross sales increase, so too does the dollar value of the royalty.

The steepness of the curve initially will depend on the rate of sales growth in a new outlet, which slows as the business matures.

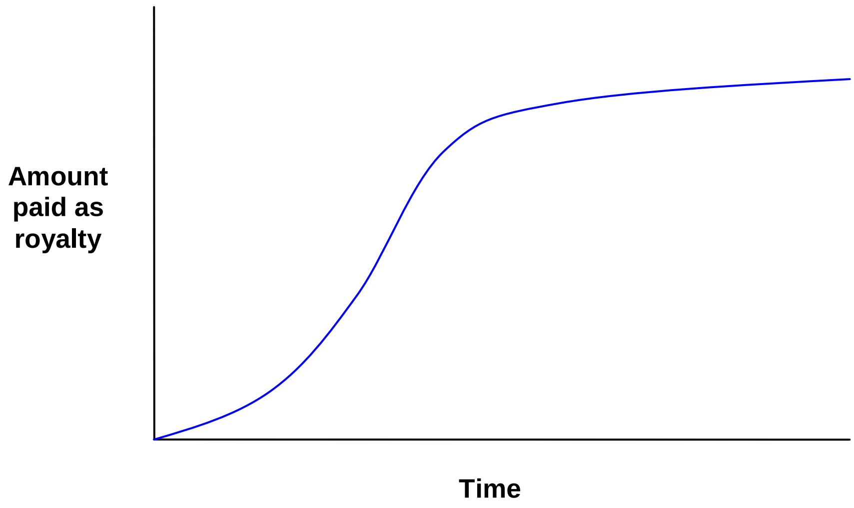


Figure 3: A graph showing the Fixed Percentage Amount method of franchise royalty over time.

This type of royalty requires much greater sophistication in franchisee monitoring in order to be effective. Best practise is to link franchisee point-of-sale systems with head office so that sales across the entire network, and in specific outlets, can be monitored live in real time. This also allows for royalties to be calculated by the franchisor based on the payment period, and levied immediately, rather than waiting for reports to be provided by franchisees.

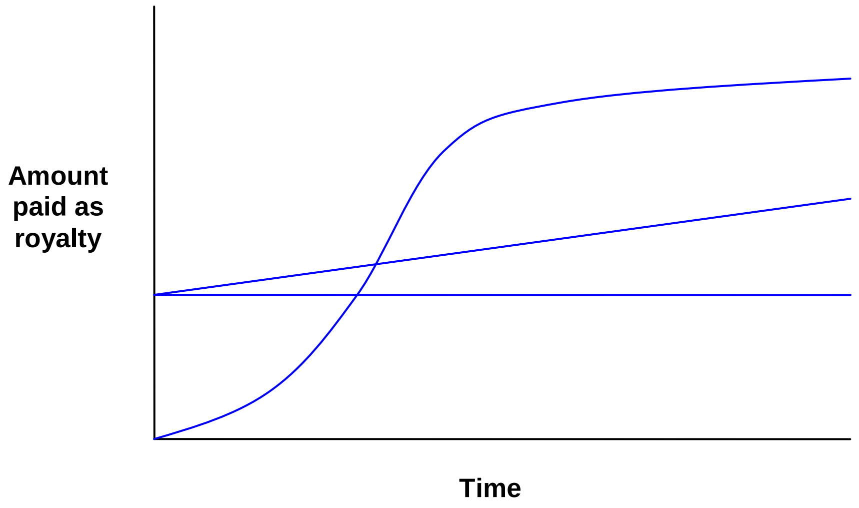


Figure 4: A graph showing all three royalty models together

To simplify our understanding of these three royalty models, they have all been summarised on the one graph in Figure 4 above. This shows the relative cost of each type of royalty over time.

When viewed as a "user-pays" service, franchise royalties remain flat or increase over time, either as a function of price increases, sales growth, or both.

By contrast, the level of support provided by a franchisor is at its greatest when a new franchise commences in order to help the franchisee establish themselves in their market, and to ensure operational proficiency as quickly as possible.

Franchisor support to franchisees is generally delivered at maximum levels at the outset, then as the franchisee becomes more capable in the operation of their business, the franchisor is able to reduce its support to a more consistent, ongoing level.

The level of support provided to a new franchisee over time is mapped against the three royalty models in Figure 5.

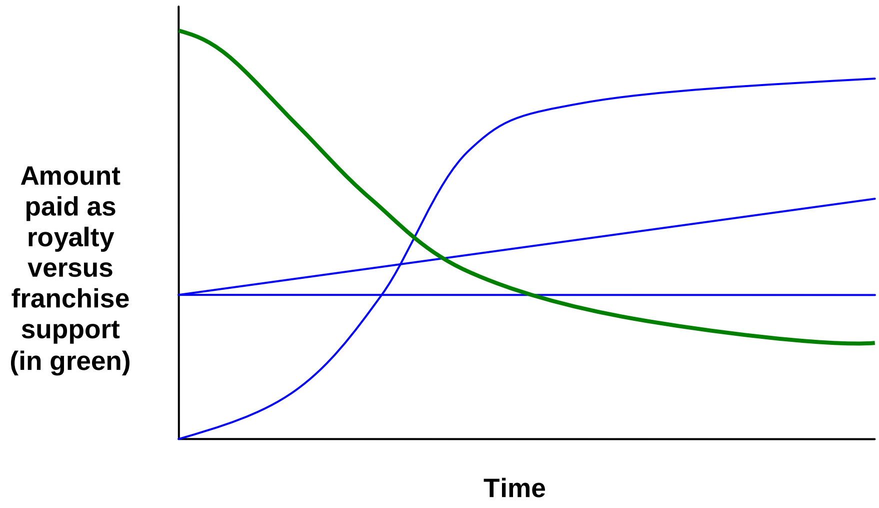


Figure 5: Graph showing all royalty models, compared with levels of support provided by the franchisor.

This graph shows that franchisees receive the most support from their franchisor at the commencement of their franchise and pay the least in royalties. It also shows that as time passes, franchisees pay more in royalties for diminishing levels of support.

Consequently there is an inversion in the value proposition of the financial relationship between franchisee and franchisor.

While this inversion is necessary for the franchisor to be profitable, it does not necessarily follow that the inversion creates profit for the franchisee, and indeed, may actually reduce profit as fee costs rise.

The divergence between the royalties paid and the support offered provides a structural basis for conflict to emerge in the relationship between franchisees and franchisors, often crystallised by the simple question posed by established franchisees to their franchisor: "*What am I getting for my money?*"

This session will explore these three royalty models, possible solutions to overcome structural problems in the value proposition, and examine the nature of support provided by franchisors to franchisees.

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