

INTERNATIONAL DEVELOPMENT

# Establishing and Justifying International License Fees

The franchisor and the licensee need the chance to make an acceptable return on investment.

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This analysis is based on the more than 100 years of collective international operating experience, specific market research and work done for more than 40 different franchises of various types and sizes in more than 50 countries ranging from emerging markets to highly developed countries.

The bottom line: no matter what method is used to calculate the initial area or master license fee, it needs to allow both the franchisor and licensee the chance to make an acceptable return on investment.

## Area License

Food franchises normally grant area licenses for a certain number of units rather than a specific geographic territory. They often set their initial international area license fees based on their U.S. unit franchise fee times the number of units in the license. Hence, a 10-unit license for a franchise with a U.S. \$50,000/unit franchise fee is usually U.S. \$500,000 for the initial international area license fee.

A franchise specific additional training fee of U.S. \$30,000 to \$50,000 is often added as an itemized fee, due to the extensive nature of initial training and business launch support involved with restaurant brands.

Area licensee candidates are often interested in the rights or option to sub-franchise. However, such discussions, rights and related fees are most often deferred until the licensee demonstrates a superior development and operating performance of their in-country units, if at all. Most food franchises do not allow sub-licensing because of the great potential to lose brand integrity. Some retail franchises also grant area licenses with no right to sub-franchise.

Franchisors that use area licenses to grow globally include such franchises as Carl's, Jr., Baja Fresh, The Melting Pot and Round Table Pizza.

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## Country Master License

For the more typical master license granted by service, retail, education and other franchise concepts, an initial master license fee is charged based on franchisor costs and on the expected number of units to be opened in a country under an agreed development schedule. It is also common for the franchisor to earn an appropriate profit from the award of a master license.

Franchisors that grant country master franchises to grow globally include Mr. Handyman, Signs Now and Two Men and A Truck.

There are numerous methods of establishing the initial master license fee for a particular brand and country. Some franchisors merely set a fee based on the size and sophistication of the country. Hence, under this model the initial master license fee for the United Kingdom, a highly-developed, large country, would be significantly more than for Kenya, a smaller, emerging market country. Some franchisors use a sophisticated model that projects revenue and expense at the unit and master level and the number of units to be opened over the period of time—say five years—and then sets the country's initial master license fee by calculating the rate of return for the master of the business is done to the franchisor's standards.

## Cost Recovery Method For Initial Master License Fees

One method is to set the initial master license fee based on the recovery of costs associated with the development of the franchise over time plus the cost to put a licensee in place in a country. Using this method, experience tells us that the franchisor should budget into the initial fee all their costs for the first two to three years of country master licensee operations. In the early years there will be few units open and their turnover will be low. It is in these early years that a much higher level of training and support are essential to ensure the business is started properly at all levels.

Costs that are part of the franchisor's business and that should be taken into account when setting an initial country master license fee are as follows.

### 1. Specific franchisor country direct hard costs\*

- Market research,
- Marketing for licensee,
- Due diligence on licensee candidate,
- Local legal agreement review,
- Disclosure filings,
- Internal and external development costs,
- Staff costs—development, management, training, support, marketing, information technology,\*\*
- Travel—at start-up and ongoing,
- Initial and ongoing training
- At headquarters and in-country
- At the unit and master level,
- Initial and ongoing support
- At headquarters, start-up, online and ongoing,
- Technology transfer—Intranet, Web sites, point-of-sale, reporting package, software,
- Corporate overhead.

### 2. Allocated already invested and ongoing costs

- Franchisor business systems, standards, marketing programs certifications and manuals,
- Technology—Intranet resources, POS, Web sites, Web-based reporting and analysis,
- Software development and maintenance,
- Trademark registration and maintenance,
- Development and maintenance of marketing materials at the unit and master levels.

Note that the above costs do not include a fee related to the number of units that can be opened in a country. It is standard worldwide to consider the specific market potential when granting a license. And it is common to include a small profit by the franchisor for the award of the country license.

While there must be a focus on the franchisor's cost recovery as a factor in establishing an absolute minimum initial master license fee per territory, there are numerous additional factors incorporated into establishing fees for each market and on a case-by-case basis. These factors can be many, ranging from the country's economic environment to the territory's legal and financial restrictions related to franchising.

However, for the sake of perspective and at a "common denominator level," both experience and common sense tell us that the initial fees for Ireland are typically less than that of Australia, which are typically less than the initial fees for the United Kingdom and Germany. Accordingly, the initial master license fees for Japan are usually higher than for the United Kingdom. In general this has to do largely with market size and potential.

Practice tells us that typically a franchisor should not charge a country master license fee less than U.S. \$150,000, given the trademark, legal, license sales cost, as well as the initial training and support. There may be strategic reasons to justify an exception however.

As mentioned above, initial master license fees are established based on factors that can, and do, vary by franchise brand and respective international markets. These factors most often include the following:

1. Brand value: some brands are very well known around the world, and have an immediate and nearly automatic appeal and value in the market. Such a value is often reflected in the initial fee. Most brands do not enjoy this advantage and rely instead solely on its brand as a proven, franchised business system.

2. Value of the franchise system's business model, intellectual property and know-how, as well as the franchisor master franchise revenue-sharing model as they translate to typical and projected financial results and return on investment.

3. Market size and conditions and the related development potential all things

considered such as the level of competition and capacity to differentiate the brand in the market.

4. Value of the initial unit franchise when included in the master franchise fee, which is a very common practice. Even unit models themselves vary in terms of financial potential and returns.

5. Costs recovery as described elsewhere in this article.

What is not so obvious to many are the risks of the franchisor in awarding a master license in a country to a particular entity. While there is typically a real and potentially significant upside for a franchisor, when the market is successfully developed, there are also real and potentially significant downside risks should the master licensee fail to develop the market successfully. These risks include:

1. Direct loss of income from the market.

2. Loss of brand reputation in the market and potentially in additional similar and neighboring markets. In many cases, not only was there a loss of income, it may also take several additional years before there is a realistic chance to overcome this deficit by awarding a new master license. Therefore, there is an extended period of loss of income from the market.

3. Loss of brand value for all stakeholders in the franchise organization and network.

Given the above risks, it is only logical that the franchisor should require a financial commitment from the master licensee that is proportionate to the market potential and therefore the inherent and corresponding risks. ■

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*Notes: \*During the license sale process, during the start-up phase and during the first two to three years of license operation until the licensee has sufficient units operating to generate royalties that can support ongoing franchisor country related costs.*

*\*\* There are staff development costs related to finding, qualifying, negotiating and signing a master licensee whether the development personnel are in-house or this function is provided by consultants.*