

Friction In Franchise Relationships

Franchisees and franchisors, in theory dependent on one another, quite often find their quest for profitability working at cross purposes.

Good working relationships make best hotel franchise systems effective. Those relationships are based on the concept that what is good for the franchisee is good for the franchisor. Yet, franchisees and franchisors are in very different businesses. Franchisees rely on occupancy and room rates for their profits; franchisors depend on brand distribution and portfolio size. Franchisees look to build real estate value while franchisors want to increase brand recognition.

Despite their separate agendas, franchisees and franchisors need each other to survive. But with different goals built into the same relationship, franchisees and franchisors will create friction for each other.

Impact is probably the most contentious issue between franchisees and franchisors, in all industries. Impact occurs when a new hotel in the chain takes business away from an existing hotel. It's a troubling topic because every \$100,000 in lost revenue to the franchisee means a loss

of only \$10,000 to the franchisor (royalties, reservation and marketing fees total approximately 10 percent of room revenues).

Meanwhile the new hotel may represent \$100,000 to a million dollars annually in new revenues to the franchisor. The franchisor stands to earn a substantial net benefit from impacting the franchisee. Impact is particularly threatening when the franchisor is also the owner and operator of the encroaching hotel. So far, a satisfactory formula for compensating a franchisee for revenues lost due to impact has not been established. Franchisors and franchisees continue to propose new compromises.

Termination Policies

Franchise agreements are contracts with a specified term, generally twenty years in the

hotel industry. A franchisee who chooses to leave the system is, by contract, commonly liable for the present value of estimated future franchisee fees through the end of the contract term, unless otherwise specified. For a full service hotel, liquidated damages can run into the millions of dollars (for instance liquidated damages could be the present value of 8.5 percent of gross room revenues for ten or more years).

The current movement is toward a more conciliatory approach to franchise termination among many hotel franchisors. The three common approaches are: 1) to specify an amount of liquidated damages, in the franchisee agreement that appears less onerous for the franchisee, 2) to permit a franchisee to exit if the hotel's performance is below a hurdle level, 3) to offer periodic 'windows' or points at which both the franchisee and the franchisor have the option to terminate the agreement

Purchasing Power?

Franchise companies set specifications that franchisees are required to meet when they purchase goods and services directly from vendors for key items in a hotel. Franchisors also provide a list of preferred vendors which offer special pricing to their franchisees. Most vendors in these programs provide a negotiated price, which may or may not be better than the price the franchisee can get outside the program. In other industries, preferred vendor programs are extremely restrictive.

Franchisee discontent in these industries is garnering a response in the hotel industry, particularly since preferred vendor programs are getting more restrictive in the hotel industry. In addition, the amount of profit reported by the public hotel companies from these programs is considerable and is getting the attention of franchisees.

Changes Of Ownership

When ownership of a hotel is transferred, when a hotel is sold, or when a license is renewed, the franchisor has the opportunity to reconsider whether to continue with the franchisee and hotel. Accordingly, at each of these junctures, many franchisors inspect the hotel and provide a 'product improvement plan' that must be completed for the hotel to remain in ►



"So far, a satisfactory formula for compensating a franchisee for revenues lost due to impact has not been established."

**Peggy Berg,
The Highland
Group**

Franchise companies with insufficient capital investment requirements for its franchised hotels lose customers, market share and brand value.

continued from p. 58

the system. The franchisor also has the opportunity to evaluate the franchisee. The franchisor may accept the buyer of a hotel, or refuse to let that buyer into the franchise system. There is generally a fee associated with this process, and that fee can be significant.

When a franchise company is sold, the hotel franchise agreements are part and parcel of the sale. The franchisee does not have the right to approve or disapprove the buyer of the franchise company.

Minimum Standards

Nor can the franchisee set minimum standards for the new franchisor, beyond those specified in the franchise agreement. This is a significant issue because buyers of hotel franchise companies have been known to change those companies radically,

often having a major impact on their franchisees.

Some of the most difficult situations in a franchisee-franchisor relationship arise over the issue of CapEx, or capital expenditures. Franchise companies with insufficient capital investment requirements for its franchised hotels lose customers, market share and brand value. Yet, it can be very difficult for franchisees to justify re-investment in some hotel businesses. Nonetheless, the brands that will remain strong are those that require their franchisees to re-invest. But nothing restricts a franchisor from requiring the franchisee to invest money in renovations. If the renovation requirements are frivolous, or are designed to upgrade the entire system, the franchisee may not see a return for many years, if ever.

Working Relationships

Franchising works in today's market. It provides a means for an individual to own and operate a business in a complicated world. It makes it possible for lenders to mitigate their risk when they lend to inexperienced operators. It provides national brand marketing for businesses owned by individuals. However, because of friction between franchisee and franchisor, the movement toward 'fair franchising' is gaining momentum. It is being seen in more organizations and appearing in proposed legislation. ☼

Contributed by Peggy Berg,
principal of Atlanta-based The Highland Group, a group of hotel investment advisors which specializes in franchisee-franchisor relationships in the North American lodging industry.