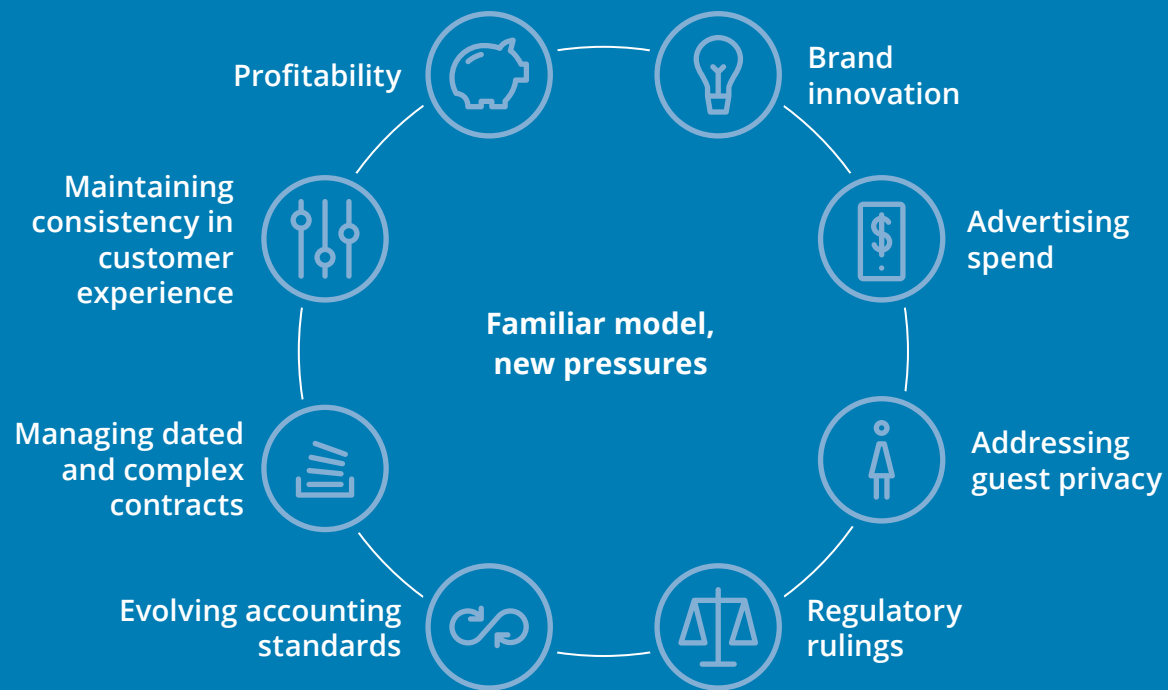


Deloitte.



**Restoring balance and
protecting value**
A franchise lifecycle perspective

Trends are converging on the franchisor model to make it more complex than before



The franchisor-franchisee relationship is a model most people understand and has historically led to mutually beneficial success. The franchisor owns the brand and related intangibles such as recipes, processes, and technology. It sets the standards, provides support services, and takes a fee in return. The franchisee owns and operates the assets, employs the staff, puts in the hours, and earns a return as an entrepreneur.

However, this traditional model is evolving in response to an increasingly riskier legal and regulatory environment. As the contractual agreements and division of responsibility become more complex, the landscape is fraught with additional pressure and risk.

In addition, there are evolving consumer, business, and regulatory trends that exert pressure on franchisors. These include:

- **Brand innovation:** In satisfying consumer attitudes, attracting the best franchisee operators, and even in the never ending challenge of drawing the best talent to store teams, expectations surrounding innovation and refreshing the brand have never been higher. Having an innovative and exciting brand isn't an option any more. It's a must-have.
- **Maintaining consistency in customer experience:** Guest expectations for service, environment, and safety are changing rapidly, and franchisors need to maintain a consistent brand and experience across increasingly complex franchise systems.
- **Advertising spend:** Often a point of contention between the franchisor and franchisee, the efficient and effective deployment of advertising spend remains a key topic for franchisors. Regional versus national priorities and the voice of the franchisee in allocating spend are key dimensions of the issue.
- **Managing dated and complex contracts that define the relationships between franchisors and franchisees:** Franchisors are often left with contractual agreements executed years ago that do not reflect today's cyber, legal, and regulatory environment, making them difficult to manage.
- **Addressing guest privacy:** Customer interactions involve more digital/social tools. This leads to an increased need for franchisors to reassess their compliance program to incorporate franchisee and third-party responsibilities regarding data capture, protection, and disclosure.
- **Evolving accounting standards:** The franchise model is impacted by new revenue recognition and lease accounting requirements.
- **Regulatory rulings:** Recent co-employment and/or joint employer status rulings also represent a substantial shift in the traditional franchisor-franchisee model, with increased risks to the franchisor.

The confluence of these trends results in franchisors being more responsible for managing complex relationships with the end consumer and also for the risks associated with those interactions. Franchisors face potential risks they have not encountered before—including the prospect of being included in legal actions against their franchisees, from which they may previously have been excluded. At the same time, franchisors can't employ so much oversight and be so prescriptive as to run the danger of being legally labeled a joint employer. Instead, they must strike a balance.

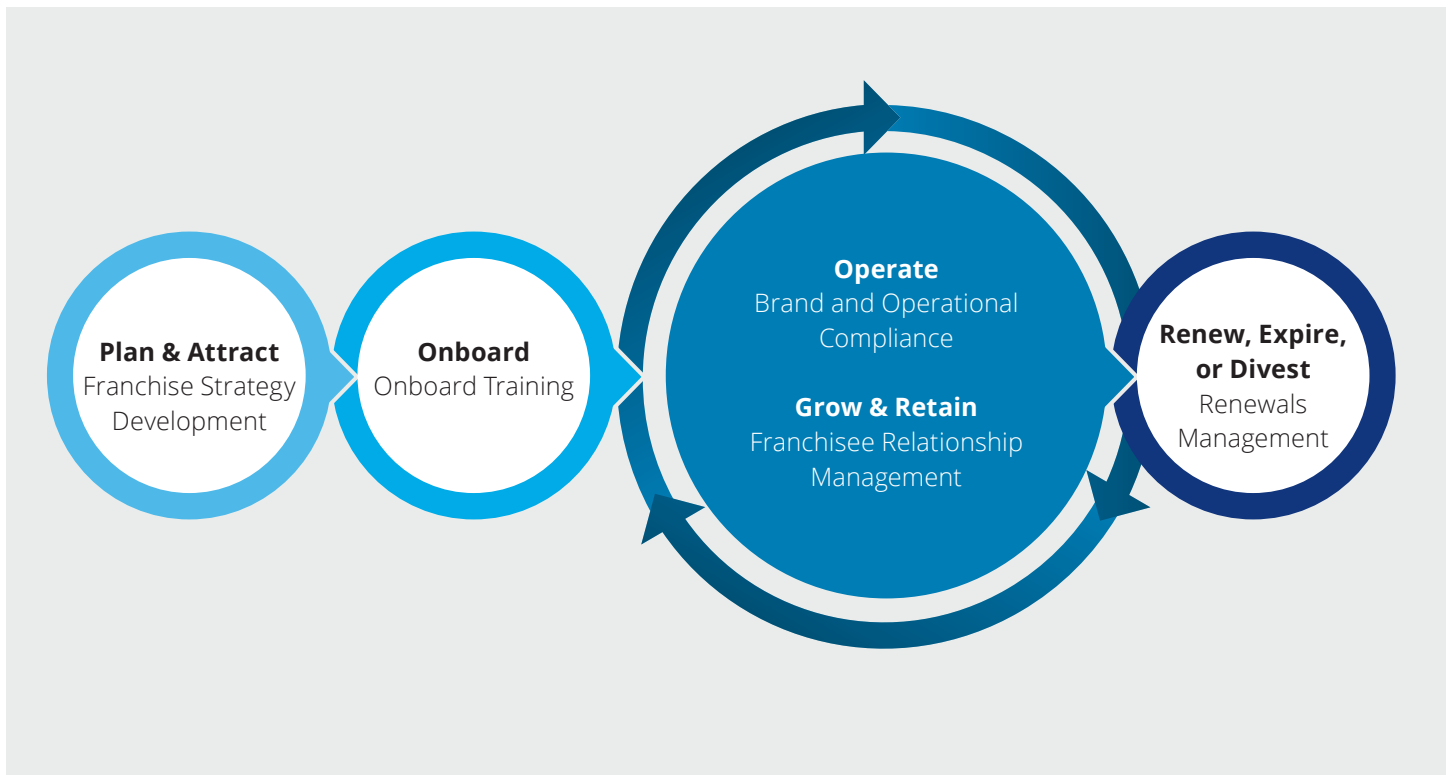
Taking a fresh look: The franchise lifecycle model

To aim for mutually beneficial success, effective franchisors should benefit from taking a lifecycle view that spans the entire relationship—from the first time the two parties engage up to, and including, the point of any potential dissolution.

Taking this lifecycle view can make it easier to maximize return on investment and to manage risk over the longer term.

This lifecycle begins long before anyone signs a contract and encompasses five core areas Deloitte Risk and Financial Advisory has identified based on our work with franchisors.

The Franchise Lifecycle Model



Plan & Attract	Onboard	Grow & Retain	Operate	Renew, Expire, or Divest
<ul style="list-style-type: none"> • Franchise strategy development • Operational and financial modeling • Valuation and analytics • Franchise agreement risk analysis • Market analysis & strategy roadmap • Franchisee prospecting strategy, due diligence, and territory mapping • Site performance analytics • Site selection • Franchisee financing strategy • Identification, valuation, and conversion of independent operators • Refranchising conversions from corporate • Franchise Disclosure Document development • Geographical & marketing/sales expansion • Construction management 	<ul style="list-style-type: none"> • Franchise agreement contract execution and management • Store launch planning & hiring • Onboard training 	<ul style="list-style-type: none"> • Franchise health-check monitoring • Franchisee relationship management • Guest loyalty management • Brand and customer experience measurement • Franchisee Advisory Council development and management • New concept testing • Store redesign/ brand rejuvenation • Marketing & promotions • Competitive market analysis • Territory expansion • Key management development • Franchisee incentives and rewards 	<ul style="list-style-type: none"> • Franchise sales, billing, and fees management • HR/labor management • Franchisee accounting, finance, and payroll • Supplier approval & contracts • Regulatory compliance • Brand and operational compliance management • Food safety & recalls • Store operations & performance management • Technology & infrastructure • Information security and privacy management • Franchisee licensing and permitting support 	<ul style="list-style-type: none"> • Franchisee renewal management • Conversion to corporate • Conversion to independent operator/sale of assets • Breach risk analysis • Settlement breach of contract • REIT/spin-off/lease back • Franchise consolidation strategy

Spotlight: Key areas of focus within each phase of the lifecycle

01

Start with a plan based on your overall franchise strategy. This can serve as a yardstick for identifying and vetting the right type of potential franchisees—from those who own two franchises or fewer and may require more oversight and guidance, to those who are truly in the “franchise business” and who own multitudes of locations and are likely to require very little involvement from the franchisor. Attract potential franchisees that meet the designated profile and perform due diligence prior to entering into agreements with them—particularly if you are considering working with a franchisee who owns hundreds of stores. Then, build a risk-balanced model that uses valuation and analytics to measure how well these decisions map to the master franchising strategy. Moving ahead without these steps could carry increased risk and other potential implications.

02

Onboard and train franchisees to help increase their alignment not only with specific policies and requirements, but also with the main franchise strategy they are responsible for putting into practice. A careful effort to get franchisees on board can help alleviate the cost and risk pressures that are influencing the industry today.



03

Fuel growth, retain customers, and operate effectively following the store's launch by providing technical and financial support and opportunities for innovation and expansion. A key component of growth is a focus on monitoring franchisee health, allocating costs transparently to the franchisees, fine-tuning ongoing operations, and providing consistent brand support. From a retention perspective, franchisee relationship management is paramount. A program needs to be put in place to help the franchisee fully understand the agreement and embrace it which leads to less conflict over the longer term. And, brand and operational compliance is essential to running effective operations across multiple stores.

04

Renew, expire, or divest as the franchise agreement period comes to an end. In the majority of cases, franchisors will renew agreements with well-performing franchisees with little difficulty. Still, sometimes the evolution of the business environment can require the franchisor to revisit the terms of the franchise agreement, and to seek better clarifications in the agreement language to better protect both the franchisor and franchisee. In a less frequent, but more challenging scenario, the franchisor needs to be prepared to part ways with an off-brand or under-performing franchisee. This may be a mutual process, or it may involve a contract breach. If the latter is the case, the franchisor will need to identify how the franchisee is non-compliant and manage that breach of contract. Doing so ineffectively can result in significant challenges for the franchisor.

The franchising lifecycle model is a way to visualize the franchisor-franchisee relationship that helps the enterprise to operate in an efficient manner. It also serves as a roadmap that franchisors and franchisees can leverage to manage the evolving landscape and to facilitate the identification and response to potential risks that threaten profitability.

How to begin

Franchisors clearly understand the franchise model and have operated in it successfully for decades. That said, the modern business environment has evolved around franchisors, and now is the time for a fresh look and an enterprise-wide approach. A new way of thinking, planning, and operating that gives franchisors the potential to break out of old patterns and overcome rising cost and risk challenges can yield the edge that franchisors need to succeed in today's environment.

Start with seeing the changes at each stage in the lifecycle, taking them seriously, and assessing your exposure. As we have seen, many of the pressures that are changing the franchisor-franchisee relationship are coming from external sources, so it makes sense for a franchisor to stay current on industry trends, regulatory trends, and other news so its stance can be deliberate and not reactive.

While many of the forces acting on the business model are external, the means for addressing them are internal. A solution is to keep channels open. By talking to franchisees about these shifts, sharing information, and working together to consider how to respond, both parties can find themselves on a surer footing when it's time to make important decisions—or to absorb blows from outside the relationship.

As legal and industry expectations change, it's natural to examine how they may influence changes in operational procedures or contract terms. It may be necessary to revisit the apportionment of costs and other financial terms. But it's also important to look ahead to how risk exposure may change—including how the apportionment of risk between franchisor and franchisee may change.

However a franchise elects to prepare for and respond to these shifts, the strategy must flow throughout the organization. That puts a premium on franchisee training. The old manual can't address a new reality. What do franchisors need to know about the relationships they are entering into or expanding? How do the parties share responsibilities as employers, as legal and financial entities, and as components of a brand to which consumers bring ever-more-stringent expectations?

Conclusion

Pressure on the traditional franchise model is coming from multiple directions. Consumers demand more integrated experiences with a brand experience, and—from their point of view—the division of accountability that separates franchisors from franchisees means nothing. Meanwhile, courts and regulators are chipping away at the firewall of ownership and responsibility that made franchising a distinct model in the first place.

All of this means that franchisors cannot afford to rely on long-held assumptions about their role in the business model. There are new demands by the customer that are constantly evolving and with the regulatory changes a franchisor cannot approach talent, risk, training, or relationships the way it did only a few years ago. Some of those changes are easy to perceive. Some are in the headlines. But the second-order changes that cascade outward from them are less easy to appreciate without deliberate effort.

For most of its history, the separation that was built into the franchise model was a large part of what made it attractive to participants on both sides. If the age of the “extended enterprise” is on us instead, the old paradigm won't address risk; it will invite it. The franchisors that move most decisively to embrace the new reality will be the ones better prepared to prosper in it.

Contacts

Rebecca Chasen

Partner | Deloitte Risk and Financial Advisory
Travel, Hospitality, and Services Leader
Deloitte Financial Advisory Services LLP
rchasen@deloitte.com
+1.617.437.2315

Kevin Lane

Partner | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
kelane@deloitte.com
+1.214.840.1577

James Cascone

Partner | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
cjcascone@deloitte.com
+1.714.913.1056



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