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Pricing Strategies And Fee Structures In Franchising Organizations

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ABSTRACT

Franchising, as a popular form of small business, continues to grow at a phenomenal rate throughout the world. Two of the most important aspects of the franchisor/franchisee relationship are the determination of pricing and a fee structure. These elements have a profound impact on the profitability and success of a franchise business. This study examined pricing strategies and fee structures across different types of franchising organizations. It was found that a variety of methods were used to determine pricing and fee structures.

FRANCHISING AND THE SMALL BUSINESS ECONOMY

Franchising is the fastest growing method of doing business in the United States today, and is now rapidly spreading throughout the world (2). Franchised businesses accounted for a third of all U.S. retail sales in 1987. This figure is expected to go up to 50 percent by the end of the century. Destined to be "the wave of the future," more and more small businesses are adopting this business method throughout the world.

The reasons why franchising is such a favored method for small businesses are many. First, franchising offers a less risky alternative to entrepreneurs who are desirous of starting their own business. In addition, the franchising method provides entrepreneurs the opportunity to develop a business at a much more rapid pace than might otherwise be possible with one person's limited capital. Last but not least, it provides the entrepreneur with the security of many individual franchise business owners who share a vested interest in the success of the business.

PURPOSE OF STUDY

Given the increasingly important role of franchising in our small business economy, it is essential that we understand the nature and functioning of franchise institutions. The present study represents one of several attempts undertaken by the authors to investigate important strategic aspects of franchising organizations. This particular paper focuses on pricing strategies (retail prices charged to consumers) and the determination of franchise fees (payments made to franchisors by franchisees) in retail franchising organizations - a group of businesses which has been ignored in small business research. The purpose was to shed light on how pricing and franchise fee decisions are made by corporate headquarters.

THE NATURE OF PRICING IN FRANCHISING ORGANIZATIONS

Pricing has always been regarded as a critical element of business strategy in retail industries. Its strategic role is assuming even greater importance today in the light of increasing competition, greater consumer awareness, and its important effects on profitability. A carefully developed pricing strategy is often a key to competitive advantage. Even though the importance of pricing has been recognized (4, 11, 15), only a limited amount of research exists which guides price determination in retail industries. Research is even more limited when it comes to understanding pricing among franchising organization. (6).

In franchising organizations, the pricing decision is usually highly correlated with the fee structure (discussed in the next section). The pricing decision enables the organization to determine the price mix that will result in the highest contribution of profits, considering the interplay of price, fees, and volume factors (12). The special nature of pricing decisions in franchised businesses poses several major problems for the development of a pricing strategy for such businesses (7, 14).

First, the determination of appropriate pricing structures is very difficult and often highly subjective (9, 10). Invariably, managers make pricing decisions by analyzing competitive prices and associated cost structures. However, it is often difficult to ascertain the relative importance of each factor in the final price determination. Furthermore, a franchisee or consumer may determine a price as "acceptable-high," while another franchisee or consumer may consider the same price as "unacceptable-high" (5, 8).

Franchisors may sometimes attempt to prescribe or influence the retail prices established by their franchisees. Some may even monitor prices charged by the franchisee or provide "fixed" price lists. These price-related restrictions create severe antitrust problems. It has been a long-held tenet of antitrust laws that price fixing and price-related restrictions are per se illegal, that is, they will be condemned without an examination of their actual effect on the business or competition. [See United States v. Northern Pacific Railroad Co. 356 U.S. 1, 5, 1958 (13)].

As a result, most franchisors now avoid dictating consumer price structures to franchisees. Nonetheless, franchisors are allowed to recommend price levels to franchisees (under the Colgate Doctrine); however, they generally do not enforce nor "dictate" price structures to the franchisees (1). The retail franchisees face, however, the occasional national advertisement at an advertised fixed price with the attached disclaimer: "At participating stores only." The final pricing decision is almost always left to the franchisee.

THE NATURE OF FEES IN FRANCHISING ORGANIZATIONS

Franchising organizations, unlike other forms of small businesses, are characterized by an ongoing, mutually beneficial relationship between the franchisor and the franchisee. A unique aspect of this relationship is the provision of certain fees that the franchisee is obligated to pay the franchisor, such as the initial franchise fee, royalties, and advertising fees. In return, the franchisor provides the necessary training and ongoing support to the franchisee.

To develop, maintain, and sustain this relationship, franchisors provide numerous services to their franchisees in return for certain payment. Although the type of fees charged by the franchisor for these services are generally dictated by the industry, the initial franchise fees, royalty fees, and advertising fees are usually determined solely by the franchisor.

A problem which often arises is that a variable predicting the event (a co-variant) may vary in value during the time period under consideration (3). Training fees associated with a franchisee start-up are often more expensive for the first two or three franchise stores than for franchise units started subsequently. The question then arises as to which value of the predictor variable should be used in explaining the determination of the fee. Salary increases in the headquarters corporation may be a "time-varying explanatory variable," while the costs of the operation and training manuals may be a "constant-time variable," impacting upon the franchise fee structure.

Because pricing and fee determination are such important, yet highly related decisions for a franchising organization, we have deemed it worthwhile to investigate them simultaneously in this paper.

METHODOLOGY

In the Spring of 1989 a questionnaire was mailed to 264 franchisor organizations, all of whom were members of the International Franchise Association. Of these, 81 questionnaires were returned. The 81 responses were representative of the 264 sent as there was fair representation from each of the industry sectors that we had sought to examine. Furthermore, the non-responses were quite random and did not represent any particular industry group or sector. All the returned questionnaires were complete and usable, and they form the data base for this research.

Franchisors were asked to respond to six different types of pricing and fee structures. These are: (1) retail pricing, (2) promotional/advertising pricing, (3) initial franchise fees, (4) royalty fees, (5) advertising fees, and (6) other fees. The respondents were asked to indicate which methods they use in determining their pricing strategy or in developing fee structures. An open-ended question was used to help determine franchise fees: "If your company uses a formula to determine the amount of this fee, please write and briefly explain this formula." The data were analyzed to determine the frequencies of franchisor responses.

Demographic Information

Characteristics of the respondents are shown in Table 1. The average sale of each franchisor was in excess of $147 million. Each franchisor, on an average, operated 94 company owned stores and had franchised 259 stores. The types of businesses ranged from automobile (8 percent), fast food restaurants (24 percent), three kinds of retail outlets, and hotel chains. Details of the types of business are provided in Table 2.

Table 1. Demographic Information on Respondents

	Mean
Sales level per franchisor	$147,059,966
Number of company-owned stores	94
Number of franchised stores	259
Industry Type:	Percent
Retail	16
Retail services for businesses	19
Retail services for mass markets	19
Automobile	8
Hotel	14
Fast food/restaurants	24

Table 2. Breakdown of Respondents by Business Type

Business Types

Retail:
- Candy and Confectionery
- Convenience Store
- Retail Optical
- Specialty Retail
- Retail Home Furnishing

Retail Services for Businesses:
- Water Treatment
- Computer Services
- Leak Detection Services
- Employment
- Contractors
- Security
- Business Consulting

Retail Service for Mass Markets:
- Home Decorating
- Photo Processing
- Hair-care
- Interior Decorator
- Formal-Wear Rental
- Pets & Pet Supplies
- Rent-to-Own

Hotel:
- Hotel & Motel Chains
- Campgrounds
- Recreation Resorts

Automobile:
- Retail Automotive Parts & Accessories
- Automobile Repair
- Automotive Parts

Fast Food/Restaurants:
- Pizza
- Fast Food
- Full-Service Restaurants

ANALYSIS AND RESULTS

Suggested Prices on Regular Items

From the anecdotal information we collected, approximately 60 percent of the franchise executives surveyed responded that they do suggest prices to their franchisees. Most of the franchisees (about 80 percent) followed the suggested price list supplied by the franchisor.

The methods used by franchisors to suggest prices to their franchisees are shown in descending order of importance in Table 3.

Table 3. Methods Used by Franchisors to Suggest Retail Prices to their Franchisees

	Percent
During training sessions	68.2
By memos	59.1
In the operations manual	54.5
By newsletter	50.0
By operations director	45.5
By other methods	36.4
By salesperson	31.8
By national advertising	22.7

As Table 3 shows, price suggestions through training sessions are the most commonly used. This is not surprising since training sessions are important vehicles for disseminating the company's basic policies to the franchisees. Other widely used methods included memos, operation manuals, and newsletters.

Suggested Prices on Special Price Campaigns

Fifty-four percent of the respondents indicated that they had national campaigns with respect to nationwide specials on pricing. Fifty-seven of the franchisors believed that these campaigns were being followed by more than 90 percent of their franchisees. The methods used by franchisors for monitoring promotional prices are shown in Table 4 in descending order of importance.

Table 4. Franchisor Methods of Informing Franchisee About Promotional Pricing

	Percent
By memos	70
By national advertising	55
By newsletter	50
By operations director	40
By salesperson	35
During training sessions	30
Other methods	20
By operations manual	10

Given the short-term nature of special price campaigns, it was not surprising to find that most of the information given to franchisees concerning price specials was done through memos, advertising, newsletters, and personal contact. Based on the anecdotal information collected, we found that 65 percent of the respondents have such campaigns at least once a month, while 80 percent have them at least once every three months.

Suggested Prices By Industry Type

Industries were divided into two categories: those that typically suggest prices to their franchisees and those that do not. The results are shown in Table 5.

Table 5.

Typically Suggest Prices	Percent	Do not Usually Suggest Prices	Percent
Retail	100.0	Hotel	80.0
Automobile	100.0	Business Services	57.1
Mass Markets	71.4	Fast Food/Restaurants	55.6

(see Table 2 for group classifications)

Interestingly, franchisors of hotels, business services, and fast food restaurants do not usually suggest prices to their franchisees. Possible reasons for not suggesting prices may be seasonality affecting prices, building costs, perishability, variability of raw material prices in different markets, and lack of uniformity across different markets (e.g., you may not be able to charge the same price for a hotel room in Baton Rouge as you would in Los Angeles).

National Campaign Pricing By Industry Type

Industries were again divided into two categories: those that typically have special promotional price campaigns and those that do not. The results are shown in Table 6.

Table 6.

Typically Have Campaign	Percent	Do Not Usually Have Campaign	Percent
Fast Food/Rest.	77.8	Business Services	85.7
Mass Markets	71.4	Hotel	60.0
Automobile	66.7		

As expected, the fast food industry ranks high in terms of having promotional price campaigns. This may be due to the fact that mass advertising is a distinctive trait of this industry. In contrast, the business services industry seldom offers promotional price campaigns since it cultivates a more one-on-one, personal relationship with customers.

Frequency of Promotional Campaign by Industry Type

Industries were divided into two groups: frequent or heavy users of promotional campaigns (at least once a month); and infrequent (light) users of promotional campaigns (quarterly, semiannually, annually or more than once a year). The results are shown in Table 7.

Table 7.

	Heavy User	Light User
	Percent	**Percent**
Automobile	100.0	
Retail	100.0	
Fast Food	71.5	28.5
Mass Markets	60.0	40.0
Business Services		100.0
Hotel		100.0

As the results indicate, automobile and retail industries were found to be heavy users of promotional campaign. On the other hand, business services and hotel businesses were found to be very light users of such campaigns.

Initial Franchise Fee

The methods used to determine the initial franchise fee are varied. As shown in Table 8, costs associated with training, screening and approving franchisees, and on-site assistance seem to be the most important determinants of the initial franchise fee.

Table 8. Considerations for Initial Franchising Fee

	Percent Responding "Important"
Advertising	30
Franchisor Administrative Salaries	53
Training	84
Site Selection	56
Accounting and Legal Costs	53
Screening and Approving Franchisees	74
Prior Research & Development	51
On-Site Assistance	72
Store Plans/Layout	56
Manuals	9
Feasibility Study	7
Software	2
Miscellaneous	19
Not Applicable	7

Royalty Fees

Based on the anecdotal information we collected, 84 percent of the franchisors collected royalties based on a percentage of gross revenues, and 63 percent of those collecting royalties did so on a monthly basis. The royalty fee varied between 2-9 percent of gross sales with 4 percent being the most common. However, approximately half the franchisors charged over 4 percent. The results are shown in Table 9.

Table 9. Franchisor Royalty Fees

Percent Royalty Fees Charged To Franchisees	Percent Respondents
0-2	2
3	14
4	33
5	9
6	21
7	7
8	7
9 or greater	6

Advertising Fees

The anecdotal information collected indicated that 65 percent of the franchisors determined advertising fees as a percentage of gross revenues. Advertising fees vary according to the retail outlet and the need for advertising development. The results are shown in Table 10. Interestingly, 56 percent of the franchisors charged 2 percent or less, while 46 percent charged 3 percent or more. This may reflect the fact that franchisees with a mobile customer group probably benefit more from franchisor-sponsored promotions while those that depend on patronage from the local geographic market are likely to benefit more from local franchisee advertising aimed at identifying local niches and combating local market competition.

Table 10. Advertising Fees Charged by Franchisor

Percent	Percent of Franchisors
0	28
.5	4
1	8
2	16
3	10
4	9
5	14
6	7
7	2
8 or greater	2

Other Fees

Finally, the results of our study reported that 21 percent of the franchisors charged fees for leases of equipment. Other than such fees, no other fee was found to be significant.

CONCLUSION

The development of a sound pricing strategy and fee structure is critical to the success of any franchised business. In this study, a broad-based questionnaire was administered to franchisors throughout the United States. The questionnaire was used to identify the primary factors that franchisors used in suggesting prices to franchisees and in developing franchise fees. Several conclusions can be drawn from the study.

First, despite the fact that pricing is heavily regulated and controlled by anti-trust laws, most franchisors nonetheless provide suggested price lists for their franchisees and expect the latter to follow them. The vast majority of franchisors use training sessions, memos, and operations manuals to convey the suggested price list. Many franchisors conduct national campaigns with nationwide specials including pricing. Franchisors believe that the vast majority of the franchisees adopt these national price specials. It was also found that franchisors in certain industries such as retail, automotive, and service businesses are more likely to suggest prices than those in other industries; this probably reflects the level of price sensitivity which these particular industries encounter.

There are three primary kinds of fees involved in a franchisor-franchisee relationship, namely, the initial franchise fee, royalty fees, and advertising fees. The initial franchise fee is determined by the franchisor based primarily on costs associated with training, screening and approving franchisees, and on-site assistance. Royalty and advertising fees are generally based on gross revenues.

Given the vital role played by franchising in the small business economy, more research is needed to study different aspects of franchising organizations. This study, as part of an ongoing inquiry into the business strategies of franchising organizations, has shed light on how franchisors develop their pricing strategy and fee structure. This is of paramount importance to the small business franchisee, since franchisors have the sole discretion in determining fees and have great influence over the franchisee's pricing strategy. Further research may be necessary to determine the bases for the development and use of pricing and fees by franchisors.

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