# Franchising Components

## Types of Franchises

Franchised businesses fall into two different types of franchisor/franchisee relationships, business format and product distribution.

### Business Format

In business format franchising the franchisee is usually provided with a complete range of goods and/or services, including product, trade names and operating procedures. The franchisor often assists with almost everything needed to start the business, including the location of the business, the size and build-out, furnishings, initial and on-going training, inventory and marketing. This complete package is often referred to as a Turnkey operation. Click here for more information on Turnkey franchises.

Both retail product (fast food, print and copy) and service franchises (house cleaning, lawn maintenance) can be business format franchises.

Business format franchising is the most common form of franchising in the U.S. When people think of a franchise, whether it is a food, retail, service or home based franchise, just about any brand name that is recognized is a business format franchise.

### Product Distribution

Product or trade name franchising involves more of a distribution arrangement (car dealership) than a business format franchise. The franchisee obtains the right to distribute a product manufactured by the franchisor. In this type of relationship the distributor may sometimes offer other products besides those of the franchisor.

### Franchise Arrangements

A franchisor may sell single units and/or multiple locations. If a franchisee wishes to become a multiple unit operator, they follow the franchisors process in investigating whether this is a viable option for them. Franchisors typically want franchisees to meet minimum standards and then actively encourage expansion with those who own successful operations. The primary determination of the number of units a franchisee is allowed to operate is financial – a combination of liquid capital and net worth. Following is a listing of the types of franchise arrangements available:

- **Single Unit Franchise** – Franchisee owns and operates one unit.
- **Multi Unit Franchise** – Franchisee owns and operates more than one unit of a franchise, most often in the same geographic area.

- **Area Developer Franchise** – Franchisee owns a large territory with the objective of subdividing and developing individual franchise locations. The franchisor will sometimes require the franchisee to open a certain number of units within a specified time frame.
- **Master Region or Master Franchise** – The Master Franchisee owns the right to a large area with the intention of developing a number of units, also usually within a certain time frame. The difference between an Area Developer and a Master Franchisee is that the Master Franchisee also has the right, and in some instances the obligation, to sell franchises within the territory to other people.

**How do Franchisors Determine Territories?**

Territories are usually mapped out by the franchisor, most often using population density, median income statistics, and/or statistics relevant to that particular industry. These territories could be delineated by streets, cities, counties, zip codes, area codes, state or region and will often be determined by a combination of factors. The goal is for each territory to contain an optimal number of potential customers as determined by the experience of the franchisor.

**Franchise Fees (and other payments beyond initial investment)**

Franchising, based on it's framework and structure, has the franchisor providing certain elements that are paid for by fees assessed on the franchisee. Understanding the franchise fees and other related financial considerations is important, as franchise ownership may require the payment of a number of different fees. Following is a sampling of the most common types of fees assessed by the franchisor:

**Advertising Fees / Marketing Fund**

Some franchised businesses require franchisees to make payments into an advertising or marketing fund. Payment amounts can be a percentage of sales or a flat fee, paid weekly, biweekly or monthly. This fund could be for national or local advertising and some companies may require contributions to both. Advertising money may be spent on TV, radio, print media or printed materials, depending on the franchise, the age of the system, the penetration of the franchise in a market or other considerations. The franchisee may have input to where or how funds are spent, or the decisions may be driven completely by the franchisor.

**Audit Fee**

If the franchisor requires financial audits of the franchise location, the franchisee may have to pay for the cost, especially if any irregularities are found. Audit fees are common to most franchise agreements.

**Franchise Fees**

The franchise fee is the initial fee paid to the franchisor to obtain the rights to the operating system of the franchise. This fee typically covers such items as site selection assistance, training, marketing materials and operations manuals. This is usually a one-time fee payable upon signing of the contract and is typically based on the number of units or territories purchased or the size of the territory.

**Product Fees**

Some franchisors require that franchisees purchase proprietary or general products from them. The primary reason franchisors require specific product/equipment purchases is to insure quality control and uniformity across the system. All the details of required product/equipment purchases are explained in the FDD and/or the franchise agreement.

Renewal Fee

Franchise agreements most often have limited terms (5 or 10 years), and typically do not automatically renew. When it is time to renew the franchise agreement, the franchisor may require a fee be paid in order to renew the agreement. Sometimes the renewal fee can be paid in the form of remodeling or upgrades to the physical location of the franchise, but at a minimum most franchisors require the franchisee to be in full compliance with the operating system to qualify for renewal.

**Royalty Fee**

This is a fee paid by franchisee to franchisor on a routine basis for the duration of the contract agreement. Often calculated as a percentage of gross sales, royalty fees can also be fixed amounts or may be based on other factors. These royalties are paid in exchange for the ongoing right to use the franchisor's brand/trademark and system. These fees enable the franchisor to offer such benefits as ongoing support and training, research and development, and building of the brand.

**Territory Fees**

When a franchisor allows a franchisee to purchase an additional or non-standard territory, they may require a one-time fee for these rights. This fee is similar to the initial franchise fee paid for the initial territory.

**Training Fees**

Most franchisors include initial training in the franchise fee. Additional training, for franchisee or staff, may also be available and fees may apply.

**Transfer Fee**

When a franchisee sells his franchise, the franchisor may require the payment of a transfer fee as a condition for transferring the franchise agreement to the new owner (franchisee).