Franchising and the Impact of McDonald's

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ABSTRACT

As individuals decide to open or pursue a small business, an important option available to most entrepreneurs involves whether or not to purchase a franchise. An increasing number of small businesses started during the last 30 years have involved some form of franchising. One major reason small business owners choose to become franchisees is these small business franchisees are able to operate as if they were much larger enterprises.

As one analyzes franchises and franchise fees it appears there is a variety of similar fees and monthly expenses related to all franchised businesses. It appears, however, a large majority of people are confused over what fees are actually required and what the various fees entail. It also appears a large number of franchise fees and monthly expenses are based on the McDonald's Corporation fee structure. Important franchising insights can be gained by analyzing the concepts employed by McDonald's with regard to fees and expenses. When analyzing the franchises of various companies, one can easily become confused with all the terms used to discuss the multitude of fees and expenses. Franchise fees, security fees, base rent fees, percent rent fees, service fees, and royalty fees, not to mention the various purchase cost options, all come into play. Based on the research of McDonald's fee structures, hopefully, future conclusions can be made and comparisons of associated fee structures of other franchised companies can be drawn in a more enlightened manner.

Keywords: franchising, McDonald's, franchisors, franchisees, small business, franchising fees.

INTRODUCTION

Having limited funds available can be a significant barrier to someone attempting to create their own business. Historically, financial resources for the individual entrepreneur have been obtained from various sources, such as immediate family members or other relatives. Franchising serves as a financial resource multiplier, effectively allowing the entrepreneur to operate a small business with many attributes more often associated with much larger corporate entities.

A thriving large franchisor corporation is able to offer its franchisees an extremely large reservoir of resources. Experience and expertise covering all facets of business acquired from years of successful operation are two of the most critical resources franchisees gain from their relationship with their franchising entity. The typical large franchising corporation is able to offer marketing clout from name recognition in the relevant market. This is a resource that a smaller business would not be able to access otherwise.

The retail service sector, especially the restaurant sector, has become one of the more recognized industries associated with the franchising form of business structure. Many such fast food franchising ventures have proven extremely successful. The one name in this industry sector that has risen to become the pinnacle of the fast food franchising sector is McDonald's.

McDonald's first franchise was awarded in Des Plains, Illinois in 1955. From that beginning, McDonald's has steadily grown to its present dominant position in the fast food restaurant industry. Today, 70% -80% of McDonald's 31,000 restaurant locations are franchises operated by independent operators with the remaining restaurant locations serving as corporate stores. McDonald's founder, Ray Kroc, decided that he wanted McDonald's to be more than just a supplier to franchisees -- he wanted the McDonald's corporation to be able to maintain quality control over its franchisees. Hence, the plan for McDonald's franchising was born. (McDonald's Corporation, 1988).

THE McDONALD'S FRANCHISING MODEL

When analyzing a McDonald's franchise there are a variety of terms and conditions that come into play with regard to individual store franchise fees. For each McDonald's restaurant, there is an operator's lease with an assortment of fees and conditions appropriate to that specific restaurant. A portion of the table of contents from an Operator's Lease with various articles is shown as Table I. The Operators Lease is a legal document signed by the franchisee that specifically states the rents and fees for that specific McDonald's restaurant. Each individual store will have a separate and specific operator's lease. In order to understand the full magnitude of this lease and its fees, three basic agreements that can originate in the Operator's Lease become important and need to be further analyzed and discussed. These three agreements are the Conventional Franchise, the Business Facilities Lease and the Joint Venture. (McDonald's Corporation, 1988)

CONVENTIONAL FRANCHISE

The majority of McDonald's franchises are termed "Conventional Franchises." This agreement is based on a 20 year agreement between the franchisee and McDonald's Corporation. The Operator's lease for a Conventional Franchise usually includes an ongoing service fee of

approximately 4 % of the monthly sales/revenues of that particular store. This 4% is used for advertising and marketing. This may also be referred to as the advertising fee. This money is used for TV, radio, internet advertising/promotions, as well as other marketing choices. In addition to this 4%, there is an ongoing "monthly fee" (percent rent) of 8.5% to 13% of monthly revenues due to McDonald's Corporation for use of the building which is owned by McDonald's. This percent rent is also based on McDonald's Corporation owning the land and building for that particular restaurant. This rent percent can be reduced in rare cases where the franchisee owns the building. There may be a few cases where the franchisee owns both the building and the land, but it appears McDonald's Corporation usually owns the land and the majority of buildings where McDonald's restaurants are located. Hence, McDonald's has become one of this country's largest real estate holding companies; owning thousands of prime commercial locations throughout the United States. An example of estimated monthly fees is found in Table II. (McDonald's Corporation, 1988)

There are some initial costs, in addition to the "service fee" and "percent rent fee," that are also required to be paid for a conventional McDonald's franchise. These costs include a security deposit (one-time payment of $15,000) and the initial franchise fee of $45,000. These costs are tied to the Operator's Lease Agreement for each individual store. These monthly fees and deposits are in addition to the purchase price of the actual restaurant. The purchase price reflects the fair market value paid for an existing restaurant. Although there is no set purchase price, a broad rule of thumb usually sets the purchase price between 50% - 75% of the store's past annual sales for an existing and established store. McDonald's usually requires the franchisee to invest 25% of the negotiated purchase price of a restaurant from personal funds. The Conventional Franchise is further defined in Table III for purchase of a new restaurant and in Table IV for the purchase of an existing restaurant. (McDonald's Corporation, 1988)

BUSINESS FACILITIES LEASE (BFL)

A second agreement for purchasing a McDonald's restaurant is known as the Business Franchise Lease (BFL). The BFL is a program to help outstanding individuals become franchisees who may lack the funds to qualify under the Conventional Franchise Agreement. The BFL is a program for franchisees lacking the $45,000 for the franchise fee and/or the 25% down of the purchase price of a restaurant. The individual who is selected by McDonald's for the BFL will usually pay a higher base rent rate of 13% or more for 2 - 3 years until the franchisee is able to save-up the required 25% down of the purchase price of the restaurant. Since the BFL is usually purchasing a restaurant owned by McDonald's Corporation, the final sale price will again be determined by the sales volume of the restaurant. The sales price is usually between 42% - 52% of the past year's annual sales. The BFL is a popular agreement used for existing outstanding McDonald's employees who wish to become franchisees. The BFL is further defined in Table V. (McDonald's Corporation, 1989)

JOINT VENTURE

In the late 1990's, another program was started by McDonald's to enable franchisees to purchase a McDonald's known as the Joint Venture. This program was offered to existing franchisees as a way to rapidly expand with less up front capital expense. Joint Venture franchisees are essentially partners with McDonald's Corporation. For example, if McDonald's

had corporate stores that they wished to sell, they may offer them to an existing franchisee as a joint venture. The agreement establishes the payment of a management fee to the franchisee from McDonald's of approximately $5,000 per month for each store involved in the joint venture agreement (as many as 10 locations could be involved). In addition, the franchisee may get a percent of the bottom line of each store (40% - 60% - depending on the agreement in place with each joint venture franchisee). Today there is evidence that McDonald's is mainly using the joint venture agreement with franchisees in countries outside the U.S. (McDonald's Corporation, 1988) (Elango, 2007)

ADDITIONAL McDONALD'S OPTIONS

McDonald's has also located restaurants in various retail stores within the past 10 to 15 years. Locations like Wal-Marts, airports, hospitals and universities that house a McDonald's restaurant are usually called satellite locations, and usually are awarded to existing McDonald's franchisees in the vicinity of the satellite location. The fees and expenses for satellite locations differ from the conventional McDonald's stand-alone store locations and could serve as the basis for an entirely separate study of this type of franchising fee structure. (McDonald's Corporation, 1988)

CONCLUSION

Base rents, percent rents, security fees, service fees, franchise fees and royalty fees are all terms used to discuss franchising costs. When looking at the fees and expenses associated with any company's franchise, a good place to begin an analysis is with a comparison to McDonald's Corporation. In this paper we have laid out the 3 basic agreements McDonald's Corporation uses when franchising: the Conventional Franchise, the Business Facilities Lease (BFL) and the Joint Venture with all like associated fees. These three agreements serve as an excellent cornerstone for analyzing all companies that offer franchising opportunities. Herein, the authors have attempted to elucidate and explain the various terms associated with the numerous fees.

One must also recognize McDonald's, as with most franchises, makes money from the monthly expenses (percent rent) to the franchisee based on the restaurant's "total revenues" (and not just profits). Each individual McDonald's franchise is carefully researched prior to completion. McDonald's corporation attempts to reduce its corporate risk exposure as much as possible. If the franchise holder is successful, McDonald's corporation is successful. This concept appears to work very well for McDonald's and equally well for the motivated franchisee. Franchising is not for the "weak-of-heart" or for someone looking for an easy way to become a small business owner.

In addition to the financial requirements that one must consider when analyzing various franchise opportunities, there are numerous other basic requirements McDonald's mandates of anyone attempting to become a franchisee of McDonalds's. These McDonald's corporate requirements include such restrictions as not allowing partners (operationally or financially) when purchasing a franchise. There are also extensive training programs that franchisees must complete in order to become a McDonald's franchisee. This training can take up to two years with no compensation to the trainee franchisee. A more complete analysis of the many and varied requirements of the McDonald's franchise model definitely should be pursued as an avenue for future research. (McDonald's Corporation, 1988)

TABLE I
OPERATOR'S LEASE (SAMPLE)
TABLE OF CONTENTS

Article 1	SUMMARY OF FUNDAMENTAL LEASE PROVISIONS	
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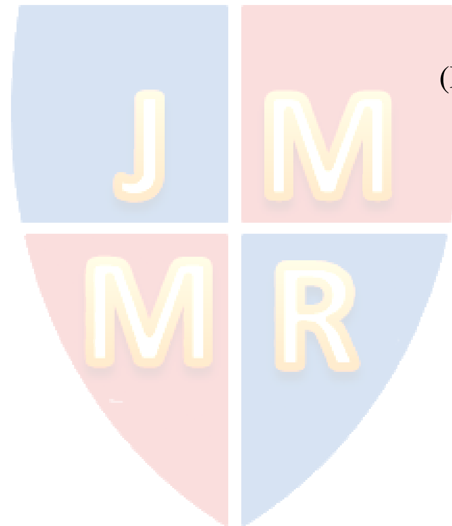
(McDonald's Corporation, 1989)

TABLE II

"Monthly Fees" to McDonald's for Restaurant – Based on Monthly Sales (Revenue) of $150,000.00 Per Month

Estimated Monthly Sales/Revenues	$150,000.00
	x.10
Percent Rent Fee (Figuring 10%)	$15,000.00
	$150,000.00
Service (Advertising Fee)	x.04
	$6,000.00

From Monthly Sales of $150,000.00 Franchisee Pays $15,000.00 + $6,000.00 = **$21,000.00** to McDonald's



(McDonald's Corporation, 1989)

TABLE III

Conventional Franchise Cost/Expense
"New" Restaurant

The following represents the fees and approximate costs of a new McDonald's restaurant. Size of the restaurant facility, area of the country and style of décor and landscaping will affect costs. 25 to 40 percent of the total costs must be funded from non-borrowed personal resources. The remainder may be financed from traditional sources. McDonald's does not provide financing or loan guarantees, nor does it permit absentee investors or partners.

Term	20 years – McDonald's Corporation owns land and building	
Ongoing Fees	A monthly fee based upon the restaurant's sales performance (currently 4% of monthly sales) plus the greater of: a) a monthly fee, or b) a percentage of monthly sales which is at least 8.5 %.	
Initial Costs	$45,000.00	Paid to McDonald's. Initial fee earned by McDonald's at the time the McDonald's restaurant is ready for occupancy.
	$15,000.00	Paid to McDonald's and subject to refund. Interest free security deposit for the faithful performance of the franchise, refundable at the expiration of the franchise.
	$537,000.00	Paid to suppliers. Approximate cost of kitchen equipment, signage, seating and décor, and pre-opening expenses.
may	$600,000.00	**Approximate Total Cost** (40% of the cost must be funded from non-borrowed personal resources. The remainder be financed.)

(McDonald's Corporation, 1989)

TABLE IV

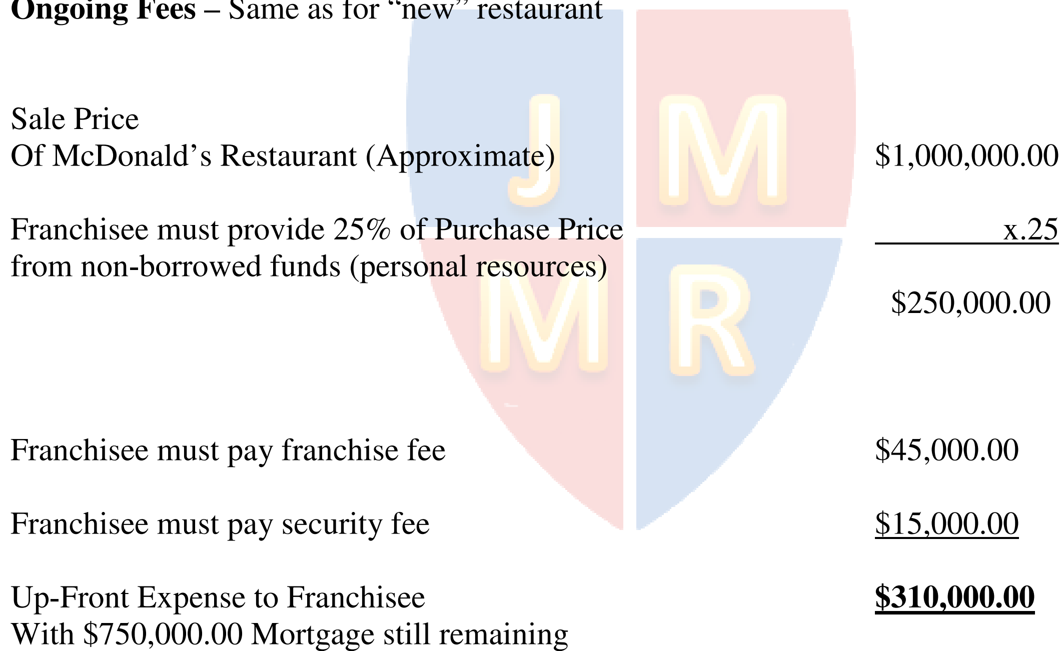
Conventional Franchise Cost/Expense
"Existing" Restaurant

Many new franchisees enter the McDonald's system through the purchase of an existing restaurant business from franchisees of McDonald's. The purchase price reflects the fair market value of the restaurant, and the buyer must invest 25% of the cost from non-borrowed personal resources. Generally, there are no costs other than the purchase price and the ongoing fees. The purchase price is usually between 50% - 75% of the store's past annual sales.

"Purchasing Costs"
For an Existing McDonald's Restaurant – Common Example

Term – 20 years – McDonald's Corporation owns land and building

Ongoing Fees – Same as for "new" restaurant



Item	Amount
Sale Price Of McDonald's Restaurant (Approximate)	$1,000,000.00
Franchisee must provide 25% of Purchase Price from non-borrowed funds (personal resources)	x.25
	$250,000.00
Franchisee must pay franchise fee	$45,000.00
Franchisee must pay security fee	$15,000.00
Up-Front Expense to Franchisee With $750,000.00 Mortgage still remaining	**$310,000.00**

(McDonald's Corporation, 1989)

Table V

BUSINESS FACILITIES LEASE

McDonald's makes its Business Facilities Lease program (BFL) available to those outstanding candidates who excel in their qualifications but are unable to meet the financial requirements of the conventional franchise program.

Over the past ten years, approximately 50% of our new franchisees have entered the system under the BFL Program.

The costs of developing and equipping the restaurant are the same for both a BFL and a conventional franchise. In the conventional franchise arrangement, the franchisee purchases the signs, equipment and decor. Under the BFL program, McDonald's purchases the signs, equipment and decor and leases them to the franchisee. The total intial investment for a BFL franchisee (approximately $66,000) must be funded from nonborrowed personal resources.

NEW RESTAURANT

Initial Costs

The following costs will vary depending on individual circumstances and do not include living expenses prior to opening of the restaurant.

$15,000	Security deposit
12,000	Inventory
6,500	First month rent
$32,500	Pre-opening expenses (i.e. training, advertising, uniforms, etc.)
$66,000	**Total**

Term

3 years.

Ongoing Fees

A monthly fee based upon the restaurant's sales performance (currently 3.5% of monthly sales) plus the greater of: a) a monthly fee, or b) a percentage of monthly sales which is at least 13%.

Purchase Option

Available in the second and third year of the term (assuming full compliance with the franchise).

Option Price

The greater of:
a) $475,000, or
b) a percentage of the previous twelve months sales calculated as follows:

Sales Volume	Percent of Sales
$1,199,999 or less	42%
$1,200,000 - 1,299,999	44%
$1,300,000 - $1,499,999	46%
$1,500,000 - $1,699,999	48%
$1,700,000 - $1,899,999	50%
$1,900,000 and higher	52%

plus the cost of any equipment or leasehold improvements purchased by McDonald's, leased to the franchisee and installed after the restaurant has opened for business.

25% of the option price must be funded from nonborrowed personal resources; the remaining 75% may be financed.

The average length of time necessary to exercise the purchase option is approximately two years and is principally affected by the franchisee's ability to generate sales and control expenses.

The terms upon exercise are as follows:

Term

Normally twenty years from the beginning date of the Business Facilities Lease.

Ongoing Fees

Reduced to those in effect for conventional franchises.

EXISTING RESTAURANT

Many new franchisees enter the McDonald's system by acquiring existing restaurants through the BFL program. In these cases, the initial costs are somewhat less than those for a new restaurant. In addition, the option price may vary depending upon the fair market value of the restaurant. Generally, the ongoing fees are the same as those associated with new restaurants.

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(McDonald's Corporation, 1989)

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