Pricing Franchises

Pricing is always a tricky process. A company never likes to under price what it is selling because it is leaving money that could be in its coffers behind. The urge is to price high and see how the market reacts. Unfortunately, this is not a viable approach because the market will almost certainly react negatively if what you are selling is deemed not worth what you are selling it for. Therefore, the challenge is to estimate the value your buyers most likely will assign to your product/service, compare yourself to other players in the market, and set the highest price possible.

Naturally there are times when a company intentionally opts to sell at a lower price. Insofar as this article is not a discussion of pricing per se, but rather the pricing of franchisees, the discussion of value pricing is not applicable. In almost all cases, the pricing of a franchise seeks to maximize revenues, and not appeal to a wide range of buyers.

Pricing issues for a franchise have two components. They are:

- Pricing of the franchise fee or the initial sum of money the franchisee must pay in order to purchase the franchise, receive the training, and gain the right to operate the franchise.
- Pricing of the royalty the franchisees pay on an on-going basis as part of the franchise agreement. The royalty is typically a set percentage of the revenues.

Franchise Fee

Beyond our discussion of pricing as a function of market tolerance and competitive necessity, the factors to consider when placing a price on your franchise fee are:

- The value of your brand name – the more your name is well known and well respected, the greater the value and the higher you can charge
- The number of franchisees – as your system grows and you have a large number of franchisees you can increase your price as the demand for the units can be considered greater
- The profits of operating units – if your units are highly profitable and you are able to demonstrate that through existing units, you can charge more because you will be able to show the return on investment.
- The degree of training – if you provide a high degree of training and on-going support you may be able to command a small premium as prospective franchisees may see added value in your guidance.
- Additional costs – some franchises have low franchise fees but require a great deal of capital to get the business up and running. You need to measure the total cost (franchise fee plus necessary capital) when determining your franchise fee so that the total cost is not more than you typical target franchisee can afford.
- Competition – as with all pricing, you need to take a look at your competitor's pricing and how that policy is affecting sales. If you are offering more service, a better system, a higher profile brand, etc. you can charge more. If your competitor has an established name and a longer time in the market, you may want to charge a bit less.

Royalty Fee

When determining your royalty rate you need to be aware of two very critical points:

- The royalty rate is your primary source of revenue and makes up more than 90% of the money you will receive from franchisees over the course of your business.
- The royalty rate comes off the revenues and not the net profit, meaning that you need to be certain to leave enough in the business for the franchisee to extract from it what he/she needs to make the proposition worthwhile.

These points raised, arriving at a royalty fee takes into consideration the following:

- The nature of your industry – certain industries have more or less set percentages for royalties. Since royalties are on-going it is difficult to create the perception of value necessary to justify a markedly higher percentage than the industry norm. Therefore, if you are in an industry where many of your competitors are already franchising and they all see to be requiring the same royalty, chances are you will be boxed into this rate as well.
- The operating margins of your business – you need to keep in mind that your royalties are an operating expense for your franchisees that comes off of the top, so if your operating margins are relatively low, you will be unable to command a high royalty rate because the franchisees will simply be unable to sustain operations.
- The need for support – some businesses are completely cookie-cutter and can be duplicated with very little on-going support. These sorts of businesses can get away with a low royalty rate because their corresponding expenses will be relatively low. On the other hand, businesses that require a great deal of continuous support may need to demand a higher fee in order to offset the costs associated with delivering service and support.
- The need for development – some businesses require constant R&D and the introduction of new products and services. Insofar as these innovations are the task of the franchisor, you will need to make certain that your royalty revenue is sufficient to support the new developments you need to regularly introduce.

Franchise pricing is a tricky business because the standard guidelines for pricing and the traditional pricing strategies are rendered inappropriate by the demands of the model. The franchising model calls for dual pricing and, when best practiced, an association between them. It would seem odd that a low franchise fee would come together with a high royalty fee, because it would indicate that most likely one of the two price points were out of sync. The best policy is to price your franchise in such a way that people will want to buy them and be able to make a living running them, and that you, at the same time, can gain financial benefit and reward. If you are able to do this, you have the definition of the classic win-win scenario.