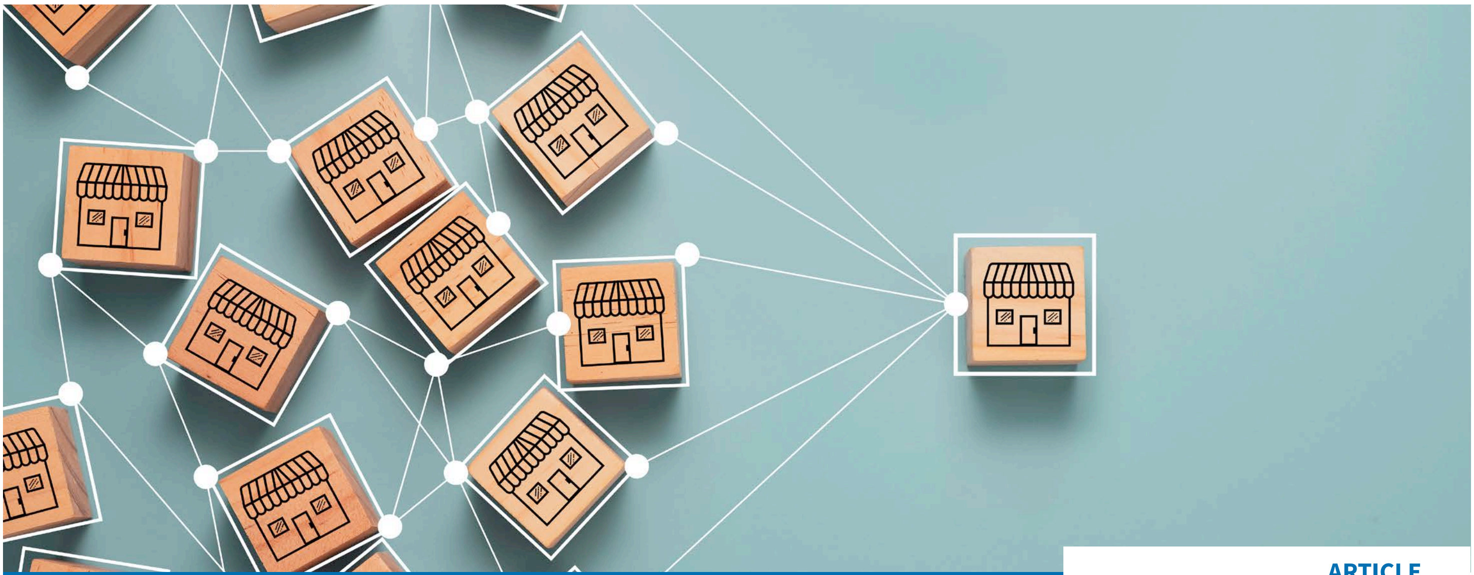

ARTICLE

The Future of Franchising and the Franchising Model

The franchising model is an important part of Australian business infrastructure. However, it continues to face unique challenges with many franchisees and franchisors still grappling with the devastating effects of the COVID-19 pandemic on available capital and trading. In this insight, we describe the legislative changes, the compounding impact of COVID-19 and how FTI Consulting is working with both franchisees and franchisors to adapt to changes and accelerate recovery in the sector.

OVERVIEW

As a business model, franchising forms an important part of the Australian economy, earning an estimated $155.1 billion in revenue[1]. Franchising touches virtually every sector of Australian business, providing a wide range of products and services via enterprises of all sizes.

However, despite its prevalence as a business model, franchising is not without its fair share of structural weaknesses and problems and the model adds unique complexities to managing a business for both the franchisee and franchisor. Many businesses in the franchising sector operate in industries that were worst hit by the state and national lockdowns resulting from the COVID-19 pandemic. For some parts of the sector, this includes a rapid shift of investment away from franchisee businesses and towards the franchisor's online capability.

The Parliamentary Joint Committee on Corporations and Financial Services ("Committee") published its report, Fairness in Franchising on 14 March 2019 ("Report")[1]. This Report states the franchising structure exhibits a substantial disparity in power between franchisors and franchisees[2]. It further states that since the last enquiry in 2008, the problems in certain franchising systems have become systemic.

In response, the Australian Government implemented legislative changes last year to the Franchising Code of Conduct ("Code") to address the issues identified by the Committee.

These changes were intended to provide greater transparency and fairness for franchisees but may also slow the franchisor's ability to respond to variable economic conditions and a changing trading environment.

[1] Burgio-Ficca, C. (2021). IBISWorld AU industry (ANZSIC) report X0002: Franchising in Australia.

[2] Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, Fairness in Franchising (Report, 14 March 2019).

Further, the challenges facing the sector have incentivised franchisors to elect to buy back franchisee businesses.

KEY CHALLENGES

Franchisors

The recent changes to the Code together with COVID-19 may have placed additional pressures on some franchisors, depending on the industry they were operating in.

The changes to the Code address the following areas:

- dispute resolution and complaints handling;
- pre-entry disclosure;
- exit arrangements and termination provisions;
- significant capital expenditure;
- marketing funds;
- passing on a franchisor's legal costs;
- retrospective unilateral change to franchise agreements;
- leasing of premises;
- restraints of trade; and
- new vehicle dealership arrangements.[3]

While the government has assessed the benefits to outweigh the costs, some franchisors at least, may have incurred costs and required additional resources to implement the changes, including drafting new franchise agreements and reports.[4]

In addition, COVID-19 has placed pressure on the supply chain, which is anticipated to continue for at least the next 12 months in some industry sectors. Supply chain issues encompass such problems as increased shipping and distribution costs, manufacturing delays, shipping delays and distribution delays. Some businesses have chosen to respond by stockpiling inventory. This will place pressure on working capital and potentially margins if increased shipping costs are not recouped and businesses are forced to exit inventory at a discount if they have not forecasted demand accurately.

It is anticipated that at least a portion of the shift from bricks and mortar to online will be permanent. This has necessitated many businesses to significantly invest to improve their online offering. The changes to Clause 30 of the Code have strengthened the prohibition of significant capital expenditure being required of franchisees unless certain conditions are met. This provides greater visibility and certainty to potential franchisees but may hamper the franchisor's ability to make fast but necessary decisions around capital expenditure when required. This shift to increased online sales as a result of COVID-19 may have also challenged historical methodologies used by some franchisors in allocating profits from online sales to franchisees.

While intended to be resolved by the changes to the Code, the failings identified in the Report are also expected to be an ongoing challenge for some franchisors as they seek to address allegations and potential actions by franchisees and regulators. Franchisors also must consider the potential risk of liability from misconduct of their franchisees. Reputation damage may also be suffered, not just by a franchisees' misconduct but also from failures to meet quality and service standards as a result of the economic impact of COVID-19 lockdowns on some businesses.

These issues have led some franchisors to 'buy-back' some of their franchisees, or in a few extreme cases, all of them – converting to a traditional corporate model.

Franchisees

The changes introduced to the Code last year are intended to provide greater transparency and fairness to franchisees. However, it is expected that there will still be key challenges faced by franchisees, particularly for those that were also struggling from the impact of COVID-19 on business performance and cash reserves. In addition to normal operating costs, franchisees are usually required to pay ongoing franchise fees and contributions to marketing funds. The state lockdowns and subsequent shift to increased online sales may also not have benefited all franchisees, and in some instances, may have fundamentally impacted their viability and business model. The ability to adapt to a new business model and change product/service offerings may have been hampered by the restrictions of the franchise agreement. It may also limit the franchisees' ability to reduce costs and increase pricing in response to economic

[3] Explanatory Statement issued by the authority of the Minister for Employment, Workforce, Skills, Small and Family Business, Competition and Consumer Act 2010, Competition and Consumer (Industry Codes – Franchising) Amendment (Fairness in Franchising) Regulations 2021.

[4] See ibid.

conditions. While changes have been made to the Code to benefit franchisees regarding exit provisions and restraints of trade, they do not go as far as to allow unilateral early termination of the agreement by the franchisee.

Post-lockdowns, the supply chain issues identified above may also be impacting some franchisees, particularly where the franchise agreement requires ordering from specified suppliers. In addition, although not unique to the franchise sector, franchisees may be faced with labour shortages. Franchisees may also be at risk of actions from business misconduct (either intentionally or unintentionally), such as the underpayment of wages. Although this issue is not unique to the franchise sector, but unlike the general business community, a franchisees' business may be 'tarred' by the misconduct of its franchisor or other franchisees in the network, without having been at fault itself. This risk is growing with the increasing focus by the community and customers on good governance and the rise of social media and the potential to be 'cancelled'.

THE FUTURE

For many businesses and their owners, the franchising model has been and will continue to be successful. It can provide a rewarding and profitable partnership between the franchisor and franchisee. Both profits and enterprise numbers are expected to grow modestly over the next five years, particularly in service-based franchises.[5] However, the franchise model has unique characteristics and some parts of the sector are currently facing a number of challenges, exacerbated by the negative impact of COVID-19. In addition, the sector has faced increasing competition over recent years, particularly in the areas of price and overseas franchises entering the Australian market, and these trends are expected to continue. It will take some time for the changes to the Code to have a positive impact and for the sector to recover from COVID-19.

HOW FTI CONSULTING CAN HELP

Our cross-sector retail team support franchisors, franchisees, and franchise lenders by:

— assessing current systems, processes, and contractual arrangements and providing an independent view on the robustness of those arrangements;

— providing expertise in leading financial, operation and transactional driven business transformation;

— reviewing franchisee payroll at the individual employee level and benchmark franchisee payroll against the relevant instrument (i.e., award, enterprise agreement, etc.);

— providing strategic communications expertise to boards and management teams on the most effective ways to communicate with internal and external stakeholders and maximise engagement with policy and decision-makers; and

— assisting boards and management teams in quantifying exposure to potential future disputes or claims by franchisees or employees.

[5] Burgio-Ficca, C. (2021). IBISWorld AU industry (ANZSIC) report X0002: Franchising in Australia.

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