

SUBMISSION TO THE PRODUCTIVITY COMMISSION

The Market for Retail Tenancy Leases in Australia

Productivity Commission, November 2007

FRANCHISEES AND THE IMPACT OF NON-RENEWAL

SUBMITTED BY: The National Pizza Association Incorporated

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FRANCHISEES AND THE IMPACT OF NON-RENEWAL

Introduction

1. The franchised business sector in Australia consists of over 5,000 businesses employing approximately 600,000 people and represents approximately 14% of GDP. The vast majority of these businesses operate from premises subject to a retail tenancy lease.

About the National Pizza Association

2. The National Pizza Association was formed in 1999 for the purpose of representing all Pizza Hut franchisees in Australia. Today there are 129 Pizza Hut franchisees, including 128 independent and 1 corporate Franchisee operating approximately 266 Pizza Hut outlets and employing approximately 4,500 people in Australia who rely on the National Pizza Association to deal with complex issues on their behalf. The Association provides Pizza Hut franchisees the opportunity for collective representation at meetings with the franchisor, government agencies and third parties.
3. The Association has elected executives that represent the various regions in Australia. The Association currently has 5 executives and a President. From time to time, the Association may form committees to review various matters of interest on behalf of members. Committees can be made up of elected executives and ordinary members of the association.
4. Pizza Hut franchise agreements are generally for a term of 10 years with one further term of 10 years. A number of members are currently in the final term of their franchise agreement and, therefore, the issues of non-renewal of retail leases and franchise agreements which are raised in this submission is highly topical and relevant to Pizza Hut franchisees.

The issue of non renewal of lease

5. While the franchised business sector in Australia has proven to be successful in many ways, Franchisees are often found in disadvantaged and difficult bargaining positions due to current common practices in the retail tenancy market and in franchising practices. To illustrate this we will explain what commonly happens to Pizza Hut franchisees in the current retail tenancy market. However, please note that this submission is being made on behalf of all franchisees generally. Any reference to the practices or conduct of certain landlords or franchisors should not be considered a reference to any particular Pizza Hut landlord or franchisor or any of them.
6. Whereas franchise agreements are typically for a term of 5 or 10 years with one or more options to renew, typical retail leases for premises in a shopping centre are for 5 to 7 years with no option to renew the term.
7. In addition, it is common practice for shopping centre landlords to insist that the franchisor be the holder of the lease and a licence to occupy the premises is then granted to the franchisee. The landlord gets the security of the

franchisor as the tenant, whereas the franchisee is put in a weak position holding only a license to occupy the business premises.

8. Upon commencement of a franchise, and at times specified in the franchise agreement, the franchisee is required to invest significant capital to fitout and equip the business premises and to update and maintain the premises in accordance with the franchisor's requirements. Typical fitout costs for a new franchisee can exceed \$250,000 with additional equipment costs of \$150,000.
9. Based on the typical franchise scenario outlined above it is clear to see that the franchisee can be placed in a very vulnerable negotiating position for the following reasons:
 - (a) Since the typical shopping centre lease is 5 to 7 years with no option to renew and the typical franchise agreement is for a period considerably longer than this period, and since the franchisee has had to make a substantial capital investment in the fitout and installation of equipment to the business premises, at the end of the lease term the franchisee is forced to negotiate new lease terms with a landlord that knows it cannot easily or economically relocate to other premises. In such a situation shopping centre landlords often take an aggressive stance and exploit the weak bargaining position of the franchisee to extract rents which are much higher than the market rates. Some Pizza Hut franchisees have experienced rental increases in excess of 30%.
 - (b) Usually, the failure by the franchisee to renew the lease will be a breach of the franchise agreement. This is the case even when the franchisor is the tenant under the lease and the franchisee only holds a license to occupy the premises, as the failure to agree to new license terms is treated the same as failing to renew the lease. In the worst case scenario, the franchisee who is in breach of the franchise agreement will remain liable for royalties and other fees payable under the franchise agreement for the remaining term of such agreement, placing additional pressure on the franchisee to renew the lease (or license) "at all costs".
 - (c) Under the terms of the "make good" provisions which are contained in most leases, the franchisee must bear the cost of returning the leased premises to the original condition in which they were found prior to the commencement of the lease term. Significant costs can therefore be incurred in vacating the premises, particularly where structural changes have been made to the premises.
 - (d) The main value of the business is tied up in the goodwill of the business which it has generated through operating from the site during the term of the lease. In the event that the lease is not renewed the resale value of the business could be negligible as the franchisee will lose the goodwill that has built up during the term of the lease and which attaches to the particular location of the premises.
10. For the reasons listed above, it is clear to see that the franchisee is not in a strong bargaining position vis-à-vis the landlord or, for that matter, the franchisor. The franchisee is effectively put in a situation where most of its assets are tied to a site over which it has no security of tenure. Landlords -

and in particular shopping centre landlords who exercise a quasi monopoly position and excessive market power – are aware of the franchisee’s dilemma, and it makes it almost impossible for the tenant to robustly and competitively negotiate renewed lease terms in the current retail tenancy market.

11. Longevity of tenure at a particular site does not mitigate the problem of non-renewal of retail leases. While enjoying a longer tenure at a particular site may allow the franchise operator more time to recoup the large establishment costs of fitout and equipment, it also creates greater goodwill that is attached to the premises site. Where the lease term and any further options have been exhausted, the franchisee has an overriding need to obtain a further term of lease in order to preserve its business asset (its goodwill). An economic incentive will sometimes exist for landlords to refuse renewal of lease terms, as they can extract higher rents from a new tenant due to the goodwill which has been generated at the location by the prior franchisee. In such a situation the landlord will benefit while the franchisee who built up the goodwill at the site will lose one of its main assets, which may in reality represent nine tenths of the business value.
12. It must be noted that the problems faced by franchisees when attempting to secure retail premises in a tenant – landlord situation can often times be duplicated in the franchisor – franchisee relationship. The problems that may arise when a franchisor refuses to renew terms of a franchise agreement mirror those in the tenant – landlord situation.

The issue of non renewal of Franchise

13. The non renewal of Lease issue which can arise between Franchisee/tenant and Landlord is mirrored in the context of the Franchisor – Franchisee relationship.
14. Similar to the protections that are afforded tenants during the term of a lease under retail leasing legislation in most States and Territories, the franchisee is afforded certain protections under the Trade Practices legislation and the Franchising Code of Conduct against wrongful termination during the term or further option terms of the franchise agreement.
15. However, in the same way that a tenant can lose the goodwill built up at a location due to the non-renewal of a lease by the landlord, a franchisee is not protected from loss of goodwill where the terms of its franchise agreement have come to an end and the franchisor refuses to grant new terms. The situation where a franchise agreement is not renewed by the Franchisor at the end of the term(s) despite the Franchisee wishing to extend the relationship can be classed as a form of “passive termination”. It is appreciated that there may be instances where there are legitimate reasons for further terms not being offered. The issue being raised here however concerns the problem of what can be classed as wrongful appropriation of the Franchisee’s business through passive termination of the franchise agreement and/or Lease through non-renewal.
16. In this situation, at the end of the term(s) the Franchisor acting opportunistically effectively seeks to appropriate the business and /or goodwill which has been built up by the Franchisee through the endeavours of the

Franchisee during the term of operation of the franchised business at the premises

17. The refusal of the Franchisor to grant a renewal of the term will in the worst case scenario mean that the Franchisee must cease operating the business and will entirely lose the value of the business and the capital value of the fit out and any improvements made to the premises.
18. The value attributed to most retail franchised businesses when they are sold, is calculated on the basis of a multiple of EBITDA (earnings before interest taxes depreciation and goodwill amortisation) earnings. Where there is no franchise or Lease term remaining, no value can be attributed to the business on that basis,
19. Usually when a franchise agreement comes to an end, the franchisee's choices are extremely limited. In most agreements there are restraints built into the franchise agreement which prevent the Franchisee from operating a business or selling products which are similar to that prescribed in the franchise agreement from that site. In the rare circumstance where a Franchisee can exercise control over the lease, the Franchisee would be unable to remain in the premises in any capacity which would enable it to exploit in any way the goodwill which it has built up in the business.
20. Where a franchised business is profitable and the term of the franchise agreement has come to an end, it is not uncommon for the Franchisor acting opportunistically to appropriate the business through passive termination. Effectively the Franchisor is able to expropriate the returns on the Franchisee's investment with little or no payment being made.
21. The Franchisor is then able to either on-sell the franchised business at a multiple of its EBITDA earnings and obtain an immediate economic benefit of the sale value of the business. Alternately the Franchisor may elect to operate the business itself as a Franchisor operated store and continue to repatriate the profits derived from it.
22. A particularly onerous aspect of the non-renewal of lease relates to the obligations of franchisees to upgrade premises. Most retail leases and franchise agreements impose obligations on tenants / franchisees to upgrade and refurbish premises at certain intervals. It is common in retail leases to have provisions that require the tenant to repaint / refurbish every 5 years or on the commencement of each further option term.
23. The obligations to upgrade which are contained in franchise agreements are usually more prescriptive and onerous, this is reflected in the high cost associated with the upgrade or refit
24. By way of example the cost of upgrading a Pizza Hut takeaway outlet is in the range of \$40,000 - \$70,000 for a minor upgrade and \$200,000 - \$300,000 for a major upgrade. The cost of upgrading a Pizza Hut full service restaurant is in the range of \$150,000 - \$250,000 for a minor upgrade and \$400,000 - \$600,000 for a major upgrade.
25. The problem for franchisees and tenants arises when the Franchisee / tenant reach the final term of the franchisee agreement / Lease and is required to upgrade. The decision to upgrade is one that is beyond the control of the

Franchisee. If the Franchisee fails to upgrade, the Franchisee runs the risk of breaching the terms of the franchise agreement / Lease and losing its rights there under.

26. Upgrading a business may result in increasing the turnover of that business, however it does not necessarily increase the net profit before tax (NPBT) or the return on capital invested (ROI). In the worst case scenario, the franchisee is required to expend significant capital on refurbishment in the final term of a lease or franchise agreement where the landlord and/or franchisor has no intention of providing a renewal or further term upon expiration of the agreement. In this situation the franchisee has not had adequate time to recoup or earn a fair return on the cost of the upgrade.
27. Where a Franchisor acts opportunistically to appropriate the business through passive termination, the Franchisor obtains an additional windfall gain of premises which have only recently been upgraded at the Franchisees expense.
28. The comparison of the impact of non-renewal of franchise agreements by the franchisor and the non-renewal of lease by the landlord, and the devastating impacts either non-renewal may have on the franchisee are being raised here because in practice it is often times hard to separate the two issues from the franchisee's perspective. The same predatory and opportunistic practices of some landlords due to the inherently weak bargaining position of franchisee tenants under the current system can be, and sometimes are, practiced by franchisors in the current system. While this submission, and our recommendations or proposals set out at the end of this submission, are in relation to the impact of non-renewal of retail leases on franchisees, it should be noted that in order to fully address the issues, legislative changes will be needed to current State and Federal franchising laws as well.
29. The problems experienced by franchisees resulting from the non-renewal of leases and non-renewal of franchise agreements is not addressed at common law, by the *Trade Practices Act 1974 (Cth)*, or by State or Territory fair trading or retail tenancy legislation.
30. Finally, it should be pointed out that the two issues of non-renewal of leases and non-renewal of franchise agreements are often times closely tied as there are many instances where the site occupied by a franchisee is owned by an entity which is related to the franchisor.

Recommendations

31. It is submitted that the most efficient and surest way to redress the current imbalance of bargaining power between franchisee / tenants and franchisor / landlords is by legislative amendment. In this regard, it is submitted that a "good faith" requirement be introduced into relevant State and Commonwealth legislation.
32. The proposed legislative changes would place a "good faith" obligation on landlords and franchisors to renew retail leases and franchise agreements where:

- (a) the Tenant / Franchisee is prepared to pay the prevailing market rent and / or prevailing renewal fee and royalty for leases and franchise agreements respectively; and
 - (b) the Tenant / Franchisee is not in breach of the lease and/or franchise agreement; and
 - (c) the Landlord / Franchisor do not have a “good faith” reason not to renew.
33. Examples of a Landlord or Franchisor’s “good faith” reason not to renew a lease of franchise agreement would include:
- (a) a decision by the landlord to redevelop or sell the site;
 - (b) a decision by a franchisor to cease operations in a particular territory or market.

Where a landlord or franchisor obtains a collateral benefit by passively not renewing a lease or franchise agreement and thereby appropriates the goodwill of the franchisee would constitute a breach of such Landlord or Franchisor’s “good faith” obligation to renew.

34. It is submitted that the introduction of the proposed legislative changes will have a beneficial impact to franchisees and their customers – the general public – as they will help to even out the current uneven playing field that exists in the retail tenancy market with respect to tenants / franchisees and landlords / franchisors. The quasi – monopolistic power enjoyed by some landlords – particularly shopping centre landlords – can be curtailed making cost and business planning more certain and efficient. Pegging rental increases to market rates in the absence of agreement between the parties will result in a more consistent and fairer retail tenancy market and will improve efficiencies and productivity which will benefit end consumers.