Seminar

Addressing Information Gaps in Business and Macro-Economic Accounts to Better Explain Economic Performance

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Accounting for franchises and other marketing investments
Kevin Ozan
Accounting for Franchises and Other Marketing Investments

Kevin Ozan
Senior Vice President
Corporate Controller
Agenda

• What are franchises?
• Background on McDonald’s
• McDonald’s franchise model
• Impact on financial statements
• Marketing investments
What Is a Franchise?

Franchise Agreement

Franchisor

Owns trademark or trade name
• Provides support:
  – Product
  – Operations know-how
  – Training
  – Advertising/marketing
  – Site selection
  – Supply chain/distribution

Receive fees

Franchisee

Uses trademark or trade name
• Expands business:
  – Market the product or service using operating methods

Pay fees
Two Main Types of Franchises

- Product Distribution
- Business Format
Types of Franchise Arrangements

• Single-unit Franchise
• Multi-unit Franchise
  – Area Development Franchise
  – Master Franchise
Advantages of Owning a Franchise

• In business for yourself, but not by yourself
• Certain level of independence
• Established product/service with widespread brand-name recognition
• Increased chance of success
• Standards for quality and consistency
• Pre-opening and ongoing support
Disadvantages of Owning a Franchise

- Ongoing fees
- Attempt to balance standards of Franchisor with ability to manage business independently
- Potential negative publicity
- Term of franchise agreement is usually limited and may not be renewed
What Types of Companies Franchise?

- Over 75 industries worldwide:
  - Restaurants
    - McDonald’s
    - Pizza Hut
  - Retail
    - Radio Shack
  - Lodging
    - Marriott Hotels
  - Business Services/Real Estate
    - H&R Block
    - Century 21
  - Automotive Services
    - Midas International
Benefits to Company

- More stable, reliable cash flow stream
- Lower risk
- Lower capital expenditure requirements
- Better returns
Benefits to Customers

• Business run by a local entrepreneur
• Better connection with local community
• A more efficiently run organization
Economic Impact of Franchised Businesses

- Direct contribution to the US economy*
  - Jobs – Provide more than 11 million jobs or 8%
  - Payroll – Over $275 billion annually or 5%
  - Output – Produce goods and services worth over $875 billion per year or 4%
  - Establishments – Approximately 900,000 businesses are part of the franchise system

* All percentages above are based on the US private-sector workforce
McDonald’s Corporation
Global Structure, Local Restaurants

Operations in 118 countries
McDonald’s Corporation
Global Structure, Local Restaurants

Over 31,000 restaurants – more than 75% owned/operated by local franchisees
McDonald’s Corporation
Global Structure, Local Restaurants

McDonald’s serves 55 million people worldwide EVERYDAY
McDonald’s Corporation
Global Structure, Local Restaurants

Together with franchisees, McDonald’s employs more than 1.5 million people
Multi-national Brand with Multi-local Operations

- Collection of 4,000+ independent entrepreneurs who operate restaurants in their local markets
- The Franchisees’ and McDonald’s interests are interdependent
  - One party cannot succeed without the other party succeeding
  - Dependent on restaurant sales and business growth
**McDonald’s Franchise Model**

- **Franchisee**
  - Assumes risks and rewards of owning and operating a McDonald’s franchise
  - Earns a return on investment through operating profits
- **McDonald’s**
  - Assumes risk of owning or leasing land and building
  - Covers costs and earns a return on investment through rent, royalties and initial fees
Initial Investment / Responsibility

- **Franchisee**
  - Initial franchise fee
  - Signs, seating/décor, and equipment
  - Pre-opening costs (training, advertising, etc.)

- **McDonald’s**
  - Site selection
  - Land acquisition or long-term lease obligation
  - Site development and building construction
  - Operational training and consultation
Ongoing Investment/Responsibility

**Franchisee**
- Full-time best efforts
- Adhere to operating business model
- Training
- Reinvestment (building and equipment) to comply with standards
- Advertising contribution
- Rent and royalties
- Maintain financial stability

**McDonald’s**
- Operational training and consulting
- Product and operations development
- Marketing and advertising support
- Supply chain management
- Protect proprietary rights (trademarks, logos, etc.)
- Architectural design and drawings
McDonald’s Profitability

- Revenues from Franchisee
  - Initial (franchise) fee
  - Royalty fee – generally 4%–5% of sales
  - Rent income to McDonald’s
    (base and percentage rent)

- Franchised restaurant expenses
  - Rent expense paid by McDonald’s to landlords
  - Depreciation on buildings and leasehold improvements
<table>
<thead>
<tr>
<th></th>
<th>2007</th>
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<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td></td>
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<tr>
<td>Sales by Company-operated Restaurants</td>
<td>$16,611</td>
</tr>
<tr>
<td>Revenues from Franchised/affiliated Restaurants</td>
<td>$6,176</td>
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<tr>
<td><strong>Total Revenues</strong></td>
<td><strong>$22,787</strong></td>
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<tr>
<td><strong>Operating Costs and Expenses</strong></td>
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<tr>
<td>Company-operated Restaurants</td>
<td>$13,742</td>
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<tr>
<td>Franchised Restaurants</td>
<td>$1,140</td>
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<tr>
<td>G &amp; A</td>
<td>$2,367</td>
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<tr>
<td>Impairment and Other Charges</td>
<td>$1,670</td>
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<tr>
<td>Other Operating Income</td>
<td>(11)</td>
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<tr>
<td><strong>Total Operating Costs and Expenses</strong></td>
<td><strong>$18,908</strong></td>
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<tr>
<td><strong>Operating Income</strong></td>
<td><strong>$3,879</strong></td>
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<td><strong>Company-operated Margin</strong></td>
<td>$2,869 $17.3%</td>
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<tr>
<td><strong>Franchised Margin</strong></td>
<td><strong>$5,036 $81.5%</strong></td>
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Franchisee Profitability

Sales less:
- Food and paper
- Labor costs
- Other operating costs (advertising, outside services, etc.)
- Rent and royalties to McDonald’s

RESTAURANT CASH FLOW*

* Excludes debt service and selling, general & administrative expenses
Positive Impact on Local Economies

- Supply chain – majority locally sourced
- Employment opportunities
- Source of tax revenue
  - Social taxes
  - Sales taxes
  - Income taxes
  - Real estate/personal property taxes
- Giving back to the community
  - Over $75 million for RMHC and other charities
Advertising Co-ops

- Co-ops are independent entities supported by Franchisee and Company-operated Restaurants
- Franchisees are required to spend at least 4% of restaurant sales to advertise and promote the business
  - Majority funds local/national advertising cooperatives
- McDonald’s develops overall strategy for programs for the McDonald’s System
## Franchising Rewards for All Parties

<table>
<thead>
<tr>
<th>Franchisees</th>
<th>McDonald’s</th>
<th>Local Economy</th>
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</thead>
<tbody>
<tr>
<td>Cash flow</td>
<td>Growth in income</td>
<td>Employment</td>
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<td>Equity created</td>
<td>Acceptable return on investment</td>
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<tr>
<td>Acceptable return on investment</td>
<td>Increase in market value of stock</td>
<td>Products and services sourced locally</td>
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<tr>
<td>Growth/expansion opportunities</td>
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<td>Source of tax revenue</td>
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<tr>
<td>Independent business owner</td>
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<td>Giving back to the community</td>
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