GLOBAL FRANCHISING OPERATIONS MANAGEMENT

Cases in Franchise, International, and Emerging Markets Operations

ILAN ALON

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Global Franchising Operations Management

"While much has been published in franchising over the years, this book, for perhaps the first time, recognizes the important role franchising is playing in developing countries and emerging markets around the world. As a franchise consultant for close to 30 years, I found the case studies to be as fascinating as they were informative."

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—**Dr. Rozenn Perrigot**, Associate Professor and Head of the MSc in Franchising at the Graduate School of Management at the University of Rennes 1 in France, Researcher at the Center for Research in Economics and Management (CREM UMR CNRS 6211), and Consultant in Franchising

"This is an important contribution to the field of international franchising knowledge and education. The case studies presented illuminate a wide gambit of issues facing prospective and existing franchisors and franchisees alike. Coupled with the wide range of business types, stages of development, countries and contexts discussed, the issues raised expose the reader to many crucial and contemporary franchising questions. At the same time, the reader comes away with some very interesting insights into the franchising programs of some well-known companies, like Marks and Spencer, Kodak Express, and The Athlete's Foot."

—**Callum Floyd**, Director, Franchize Consultants, New Zealand

"Dr. Ilan Alon is the authority in relation to international franchising and emerging markets. His depth of knowledge and practical advice, guidance, and insight are invaluable. *Global Franchising Operations Management* is an essential resource for any franchise professional engaged in international development."

—**Paul Cairnie**, CEO, World Franchise Associates, Ukraine

"Franchise professionals will appreciate the inside information…it's not only educational, it's also entertaining (which makes me wish I had been one of the contributors)."

—**Dr. John P. Hayes**, Gulf University for Science & Technology, Kuwait, Webmaster: www.FranchiseMastermind.com; www.HowtoBuyaFranchise.com

"This book is really interesting, especially for aspiring entrepreneurs and franchise professionals. Ilan Alon seeks to provide a framework for franchisors who wish to expand their brand locally as well as internationally. I highly recommend this book."

—**Dhawal Shah**, Founder, Way2Franchise, India

"Groundbreaking, critical information on franchising. A must-read!"

—**Dianne H.B. Welsh**, Ph.D., Hayes Distinguished Professor of Entrepreneurship, Director of Cross-Disciplinary Programs, The University of North Carolina Greensboro, USA

Global Franchising Operations Management

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Cases in International and Emerging Markets Operations

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International Franchising in Emerging Markets: China, India, and Other Asian Countries (CCH Inc., 2001)

International Franchising in Emerging Markets: Central and Eastern Europe and Latin America (CCH Inc., 2001)

The Internationalization of US Franchising Systems (Garland Publishing, 1999)

1

Introduction

What is a franchise? According to the International Franchise Association, the industry's lobby group, "A franchise is the agreement or license between two legally independent parties which gives:

- A person or group of people (franchisee) the right to market a product or service using the trademark or trade name of another business (franchisor)
- The franchisee the right to market a product or service using the operating methods of the franchisor
- The franchisee the obligation to pay the franchisor fees for these rights
- The franchisor the obligation to provide rights and support to franchisees[1]

Franchising is a commercial relationship between two entities in which one of the entities, the franchisor, grants the other entity, the franchisee, the right to use its commercial and intellectual assets for a period of time in return for fees and royalties. Fees are often expressed as a fixed sum paid in advance, and royalties are often expressed as a percentage of gross revenues. The nature of the relationship between the franchisor and the franchisee is determined by the institutions that govern franchising—franchise law, as well as the personal and commercial relations developed between the franchisee and the franchisor. Because franchising is often defined by the legal environment, multiple variations exist. Italian franchising law promulgated in April of 2004, for example, defines franchising as "a contract by which one

party grants to the other, for a consideration, the use of combination of intellectual property and/or industrial rights, know-how, technical and commercial assistance, as well as the opportunity to be part of a franchising network." Governance by contract means that appropriate institutions to enforce and support franchising should exist. The contract defines the roles and obligations of the parties.

Franchising is a hybrid form of business. It requires the franchisee to follow the rules of operations, or the franchisee may lose his/her rights to the franchise. In this way, franchising is less entrepreneurial than the stand-alone business. However, the franchisee is often an owner-operator who has a significant investment, both in time and money, built into the system. The franchisee's engagement with the business—taking risks, solving problems, and operating the business—qualifies him/her as an entrepreneur. Because the franchisee has no boss in the traditional sense, he/she is really not an employee. Therefore, the franchisee is somewhere between being an employee (whose actions are monitored and controlled) to an entrepreneur (whose actions lead to residual income). In this way, franchising possesses both marketlike relations and firmlike relations. The extent to which franchisees can act entrepreneurially depends on the size of the franchisor, how franchising is embedded within the franchisor, the legal relationship, the operational autonomy, the commercial interdependence, and the extent of mutual benefits.

From an operations perspective, franchising is a systematized method of transferring organizational know-how to agents (franchisees) while minimizing the risks involved in making investments. To the marketers, franchising is a way to reach optimal distribution, perhaps in areas where the company's own tentacles cannot overreach. Franchising can also be viewed as a financial vehicle for both passive and active investors. Real estate developers might want to buy the rights to develop certain retail concepts when building a regional

mall, for example. Such developers often buy multiple units at a time and multiple concepts to fit their desired developmental plans. Master international franchising has become the most popular method for expanding overseas as it allows one entity the control and responsibility for the development of entire countries or regions within countries. In short, franchising is a contractual agreement, a hybrid form of business, a method of distribution, a mode of entry into a new country, a financial investment, and a method of operations.

There are various advantages and disadvantages to the franchisor and the franchisee. The franchisee's biggest benefit is the slogan used by the industry: "be in business for yourself but not by yourself." The franchisee can benefit from the franchisors' brand-name recognition, proven products and methods, proven marketing systems, proven technology, know-how and competitiveness in the industry, financial assistance from the franchisor or a banking affiliate, pooled resources, and economies of scale in advertising and buying. However, the franchise dream is sometime unfulfilled as the franchisee finds that results are based on hard work and resource commitment is insufficient. Fees and royalties have to be paid, contractually, even if the residual income of the franchisee is nonexistent. The franchisor has much power over the franchisee's operations, contract, and, therefore, in legal disputes.

In addition, many benefits accrue to the franchisor. Franchisors who reach a critical level of output can spread the fixed costs over a greater number of outlets, giving them a competitive cost structure. Increased purchasing power against suppliers, economies of scale, additional capital, and the potential to expand the brand quickly are some of the benefits of franchising. On the other hand, franchisors are sometimes troubled by monitoring the franchisees' actions, controlling quality, protecting their brand, getting into legal disputes, sharing revenues with franchisees, creating new future competitors,

and limiting operational flexibility. Conflict with franchisees can lead to dissolution for a small franchisor. Failure to control for quality can lead to the deterioration of the total brand and to eventual closure.

Like a marriage, the focus of successful franchising relies on the ability of the partners to work together harmoniously. This means that franchisees are empowered and engaged, that there is a mutual commitment from both sides, and that relational norms embody flexibility and trust. Cooperative relations emerge from good franchisee selection and training, shared decision making, adherence to ethical standards, and, perhaps most important, profitable businesses.

Franchising is a huge part of the modern global economy. In the U.S. economy alone, it represents about 785 million establishments with an output that approaches $740 billion (see Table 1.1). International markets for franchising are also growing. In the United States, franchising accounts for nearly 18 million jobs (1 of 8) and a $2.1 trillion contribution to output[2] (see Table 1.2). Although reliable statistics are not available, several books have documented international growth in recent years through a variety of country and industry studies.[3] See Table 1.3 for franchise associations around the world.

Table 1.1 Franchising in the United States

	Establishments	Employment (Thousands)	Output (Billions of Dollars)		(Billions of Dollars)	
Business Lines	**Amount**	**Percent Change Over Prior Year**	**Amount**	**Percent Change Over Prior Year**	**Amount**	**Percent Change Over Prior Year**
Automotive	31,659	3.9%	$185	3.9%	$39.7	7.2%
Business services	92,714	–0.2%	$819	–0.2%	$128.7	3.5%
Commercial and residential services	70,129	3.7%	$281	3.7%	$45.8	6.9%
Lodging	26,011	4.4%	$711	4.4%	$70.8	4.0%
Personal services	130,895	2.5%	$602	2.5%	$86.2	6.5%
Quick service restaurants	152,665	2.6%	$2,982	2.6%	$194.0	4.9%
Real estate	86,825	1.1%	$341	1.1%	$51.2	0.1%
Retail food	60,841	3.2%	$484	3.2%	$38.2	6.2%
Retail products and services	99,592	3.9%	$402	3.9%	$29.5	5.7%
Table/full service restaurants	33,471	2.3%	$1,003	2.3%	$55.7	4.6%
Total	**784,802**	**2.5%**	**$7,808**	**2.5%**	**$739.9**	**4.7%**

Table 1.2 U.S. Jobs and Output from Franchising

	Percent of U.S. Nonfarm Private Sector	Because of Franchised Businesses
Jobs	11.8%	17,430,700
Payroll	9.7%	$707.6 billion
Output	9.0%	$2.1 trillion
GDP	9.7%	$1.2 trillion

This book is divided into three parts:

Part I: To Franchise or Not to Franchise

Part II: In Search of Global Opportunities

Part III: Franchising in Emerging Markets and Developing Countries

Multiple franchising systems from different industries (coffee, supermarket, clothing, photography, food, athletic wear, and farming) and different countries (Croatia, Korea, United Kingdom, United States, China, and Indonesia) are represented. The diversity of companies/industries and countries in this book gives a panoramic overview of franchising around the world, across both time and space. Executives who read this book will learn about franchising success and failures through case studies. Students of franchising will learn the key success factors of franchising around the world, best practices, and will be given the opportunity to identify franchising problems and solutions. The last chapter of the book provides insight into each of the cases along with the epilogue based on what happened after the case was written.

The first part of the book discusses the decision to franchise and offers chapters with cases on coffee franchising in Croatia and Korea, as well as an example of a large UK retailer. The first two cases, featured in Chapters 2, "San Francisco Coffee House: An American-Style Franchise in Croatia," and 3, "Trying to Create a Stir: Opening a Coffee Shop in Korea," examine the decision to franchise from both

the franchisor point of view and the franchisee point of view. In Chapter 2, the franchisor has developed a franchise system, but the system is new and the environment is not auspicious to franchising due to its immaturity and lack of supporting institutions. In the case, Tensek and Pacek are faced with the problem of should they franchise or not and, if so, how should they go about doing so. Chapter 3 supplements Chapter 2's case very well because it focuses on the franchisee perspective, looking at the same industry. There, two would-be entrepreneurs, Min-Guk "MG" Kim and Kevin Andes, attempt to evaluate whether to buy a coffee franchise in Korea. Both domestic and foreign options existed, as well as the option to open their own storefront. Chapter 4, "International Marketing and Franchising at Marks & Spencer," is differentiated from Chapters 2 and 3 as it shows how franchising is implemented in a large corporate setting. M&S is the largest UK retailer and franchising is only used in the international marketplace, in places that the company does not want to invest because of a limited market and/or high exposure to risk. Franchising has a trade-off between risk and return. While the financial risks are relatively low, the potential return is limited to the royalty stream.

Part II of the book specifically deals with the international environment, first by measuring potential demand in Chapter 5, "Estimating Demand in Emerging Markets for Kodak Express," for Kodak Express, and then selecting an international market for a steak concept from the United States in Chapter 6, "Ruth's Chris Steak House: The High Stakes of International Expansion." Market assessment and selection are interrelated aspects of successful internationalization. Estimating the potential demand is one of the prerequisites for targeting a country for international expansion. The case in Chapter 5 shows how companies can use country-level statistics to estimate the potential demand. Using income distribution and family size, the case shows how to calculate the economic potential starting with GDP. Making some assumptions about income elasticity of demand, the manager can estimate the market potential for a concept. Chapter 6

presents the analyst with the problem of how to target a country using a restaurant concept as a case. Using statistics on beef consumption and income per capita, the analyst is asked to choose the most appropriate markets for expansion, where the manager is expected to make an investment.

The third and final part of the book focuses on franchising in emerging markets and developing countries. Multiunit franchising arrangements are popular among emerging markets and developing countries. In these markets, a franchisee may be a company or a rich individual or family business that is able to purchase and develop the region. The company is often connected to the local culture and customs and is able to make the adaptations needed as well as monitor and control the system expansion. In a sense, the master franchisee becomes the subfranchisor in a given location. The master franchisee collects the fees, shares the royalties with the franchisor, and is responsible to the administration and management of the system in the host market. Chapters 7, "Master International Franchising in China: The Athlete's Foot, Inc. (Part A)," and 8, "Master International Franchising in China: The Athlete's Foot, Inc. (Part B)," feature the case of a master franchisee Rick Wang, owner of RetailCo, who franchised the American Athlete's Foot concept in China. At the time of entry, the situation was ideal, large pent-up demand for branded athletic shoes was matched by opening for space in department stores and on street fronts. Shortly after opening and expanding the Athlete's Foot system in China, Rick got into trouble and started to lose sales to the brands themselves that opened direct channels to the consumers. How Rick has managed to avoid financial collapse is instructive to would-be master franchisees considering a purchase of a foreign system into an emerging market. The last case, presented in Chapter 9, "Social Entrepreneurship and Sustainable Farming in Indonesia," shows how franchising can be used to create social change. In this organic farming case situated in Indonesia, microfranchising is proposed as a

model to expand this social business. Microfranchising is franchising for the bottom of the pyramid and these businesses attempt to be inclusive to the poorest.

Collectively, the cases presented in these chapters show managers how to think about franchising from a multinational and multi-industry perspective. Both franchisee and franchisor considerations and problems are discussed. The final chapter shows what has actually transpired and provides an analysis and epilogue, where available, for each of the cases. It is hoped that this book, along with the cases presented, will show future practitioners how to franchise, under different institutional environments, and how to select and operate in different world markets.

Table 1.3 National Franchise Associations, Members of World Franchise Council, WFC

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