Thornhill Capital

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## Franchising in China

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Franchising is the practice of using another firm's successful business model. The franchisor utilizes a franchise as an alternative to building chain stores to distribute its goods or to sell its services. An agreement is entered into with a franchisee or operator who, unlike a direct employee of the company, is incentivized by having a direct stake in the business. The operator uses the supplier's trademark and distributes the supplier's goods, or supplies the services. In return, the operator pays the supplier a fee. [2]

Franchising is not primarily about the product, but about a business system that delivers the product or service. According to MSA Worldwide, it's about the entire method of doing business, the name, the product, décor, and methodology of delivery that's franchised. Franchising in China is a rapidly growing business. When we think of franchising we typically think of fast food franchises. But franchising encompasses many service industries including high tech, healthcare providers, real estate, retailing, hotels, and so on. It generally creates powerful distribution channels, high returns on invested capital which is non-dilutive to the franchisor, and decentralization of the cost of operating a local operation. [1, 6]

Franchisees tend to be more efficient cost managers than franchisors, as the franchisee is spending his or her own money. As a result, spoilage and shrinkage are reduced and labor costs are better managed. Franchisees therefore have a higher success rate than independent start-up companies. This is due just as much to their hard work as to the product or service they provide. In addition, franchisors can ensure that their systems of operation, product lines, trade dress, marketing, and other facets of their franchisee's operation are in compliance with the franchise agreement, or the franchisee can lose their investment in the business.[6]

One of the reasons that franchising has become so popular is that it allows manufacturers, retailers, and services companies to quickly open more locations than they could using corporate funds, which are often in short supply. In addition to conserving corporate cash, franchising also allows a company to keep their management and labor numbers low. Franchisees now have the burden of providing local management and labor for the franchise locations as well as addressing quality and service issues.[6]

With 1.3 billion people, and a growing middle class, franchising has become the preferred method for brands to access the Chinese market. Chinese consumers want to enjoy Western-style prosperity and services and, just as with other global consumers, they want better choices, convenience, products, and services. Franchising satisfies this need. [4]

Chinese people have an increasing annual income and a decreasing amount of time. Disposable income increased 13.4% in the past year alone and, with a preference for foreign goods and services, Chinese consumers have an affinity for branded goods and services that fit in with their busy lifestyles. But in order to be successful, franchises have also had to adapt to Chinese business practices, culture, and tastes. Take for example KFC, which has franchised in China since 1987. The company had to modify, among other things, its *finger lickin good* trademark, which translated into Chinese as *eat your fingers off*. KFC, and many other franchises, have found that the best policy was to open a corporate store in China first, learn and adapt to local tastes and vagaries, study their market, and then franchise. That's because China is not a single market, but is made up of various micro-segments where areas of the countries, and even areas within a city, have different tastes and varying perceptions of a product or service.[4] Other food franchises that have also been successful in adapting their tastes and marketing practices include: McDonald's, Starbucks, Papa John's, CKE Restaurants (Carl's Jr.), Dairy Queen, Cold Stone Creamery, T.G.I. Friday's, and Subway, to name a few. Other companies, such as Burger King and Domino's, may have been less successful at gaining the market share they desired because they weren't able to localize their products within the country or to the various micro-segments.

In addition to fast-food companies, service businesses have also been successful with franchising in China. Take for example AlphaGraphics and Sir Speedy. They both entered China in the 1990s, recognizing that there were few places where a Chinese or foreign company could get a full range of printing services, and where the staff spoke English. RE/MAX and Century 21 have franchised in order to take advantage of the boom in home ownership.[7] Many other service companies continue to enter China providing the needed expertise and skills required by an increasingly sophisticated consumer environment.

The Chinese consumer expects a high-end experience from Western franchises, given that purchasing from these franchises is significantly more expensive than buying from local Chinese providers. Take, for example, the fast-food industry where Pizza Hut is a good illustration. In the United States, Pizza Hut is not considered a fine dining restaurant, irrespective of the taste or quality of the food. It's a chain restaurant that offers reasonably priced food. In China, however, part of the success Pizza Hut has experienced is due to not only its ability to localize the food, but also to the fact that it doesn't present itself as a fast-food restaurant. Instead, it presents itself to the Chinese consumer as a fine dining restaurant.[5] The Chinese consumer subsequently feels that the higher price they pay for pizza is justified by the fact that they're eating in an upscale Western establishment.

China has the most franchises

of any country in the world,[2] and franchising is expected to continue its rapid growth for at least the next decade. In the United States, the profitability of franchises account for 14% of its GDP, but in China it's only 3% – 4%. As a result, many experts believe that the number of franchisees in China will continue to grow in line with the Chinese consumer's growth in personal and disposable income. China currently has over 4,500 franchise systems operating 400,000 franchise stores in 70 industries. The top 120 franchisors own 131,413 stores and had sales revenue of $36.4 billion euros in 2010. [5]

Early foreign brands which came to China were largely unfamiliar with Chinese consumers. As such, they opened company-owned stores, or entered into a joint venture, rather than franchise. However, since China had weak intellectual property enforcement and laws at this time, many U.S. brands saw Chinese companies use their name and logo and open fake outlets. This happened to Starbucks who decided to aggressive fight back, took the Chinese company to court in 2006, and won! [7] Not everyone has been as successful as Starbucks in a Chinese Court. But the Chinese government, recognizing the importance of franchising, has enacted a more defined set of laws since that time to protect both franchisors and franchisees.

Within the next two decades the Chinese economy is projected to be the largest in the world and its middle class is expected to grow to 600 million during that time. With this growth the government has recognized that there will be an accompanying increase in the number of franchises. Therefore, in enacting new laws, it's set specific standards for franchisors wishing to franchise in China. Among these standards are franchisor obligations which specify that: [3]

- The foreign-invested enterprise (FIE) must be registered
- The franchisor must have operated at least two company-owned franchises for more than one year
- The franchisor must disclose any information requested by the franchisee

In addition, in order to meet registration requirements, a franchisor must: [3]


- Have a standard franchise agreement, working manual, and working capital requirements
- Have an established track record and the ability to supply materials
- Have the ability to train Chinese personnel and provide long-term operational guidance
- Provide a franchise agreement that's for a minimum period of three years
- Acknowledge that there may be liabilities related to certain actions taken by its suppliers
- Acknowledge that there are monetary and other penalties for infraction of franchise regulations
- Disclose at least 20 days in advance:
    - Details of the franchisor's experience in the franchised business along with their scope of business
    - The identity of the franchisor's principal officers
    - Any litigation the franchisor may have had during the past five years
    - Full details about all franchise fees
    - The amount of a franchisee's initial investment
    - A list of the goods or services the franchisor can supply, and the terms by which they supply these goods
    - The training franchisees will receive
    - Information about their trademarks, including registration, usage, and litigation
    - Demonstration of the franchisor's capabilities to provide training and guidance
    - Statistics about existing units, including number, locations, and operational results, along with the percentage of franchises that have been terminated, and
    - An audited financial report and tax information (for an unspecified period of time).

## Endnotes:


1. http://www.businessinsider.com/the-ins-and-outs-of-franchising-in-china-2011-4
2. http://en.wikipedia.org/wiki/Franchising
3. http://en.wikipedia.org/wiki/Franchising#China
4. http://www.beneschlaw.com/files/Publication/dd814687-c73a-43fa-b68b-82281684c6a7/Presentation/PublicationAttachment/1d619f19-8166-4e8c-a277-829e2c11fe2d/CI_JulAug04.pdf
5. http://www.chinadaily.com.cn/business/2011-06/24/content_12772247_2.htm
6. http://www.msaworldwide.com/franchising-resources/articles/franchising_the_engine_for_growth
7. http://edwardsglobal.com/CBR_July_September_2011_Edwards.pdf


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